Islamic Banking in Pakistan: A Critical Analysis

Shaikh, Salman

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Salman Ahmed Shaikh[1]

Abstract

Islamic banking in Pakistan has completed one decade of operations in Pakistan and now there are 5 full-fledged Islamic banks and more than 15 conventional banks with Islamic banking windows. Due to the consistent double digit growth in total assets, the market share had steadily risen to 7% by the end of 2011. However, meaningful assessment of Islamic banking requires looking at how far they have contributed to uphold Islamic principles, values and bringing about or at least working towards equitable distribution of income. But, Islamic banking industry continues to use debt based financing modes which are priced using KIBOR as the benchmark. Equivalence of means test confirms that Islamic banking spreads are higher than conventional interest rate spreads. The paper analyzes the Islamic banking philosophy, principles and practices and identifies the shortcomings which need attention of Islamic scholars as well as the regulators.

Keywords Islamic Finance, Islamic Banking, Takaful, Murabaha, Ijarah, Mudarabah, Musharakah, Salam, Istisna

JEL Codes A1 H2 G0 B5

1. Introduction

Islamic finance is a growing industry which is consistently evolving and has been resilient to reach and sustain its growth momentum despite the deepening financial and economic crisis since 2007. Total assets of the global Islamic finance industry are estimated to grow to around $1.6 trillion by 2012 according to some estimates. Some reports also suggest that assets held by Islamic financial institutions may climb by five times the current level to reach more than the $5 trillion mark in next few years (Source: Moody's Investor Service).

According to some, this growth owes to some unique features inherent in Islamic financial products. Adel (2010) explained the economic merits of Islamic banking by pointing out that credit expansion through Islamic banking is linked to the growth of the real economy by allowing credit primarily for the purchase of real goods and services. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully.

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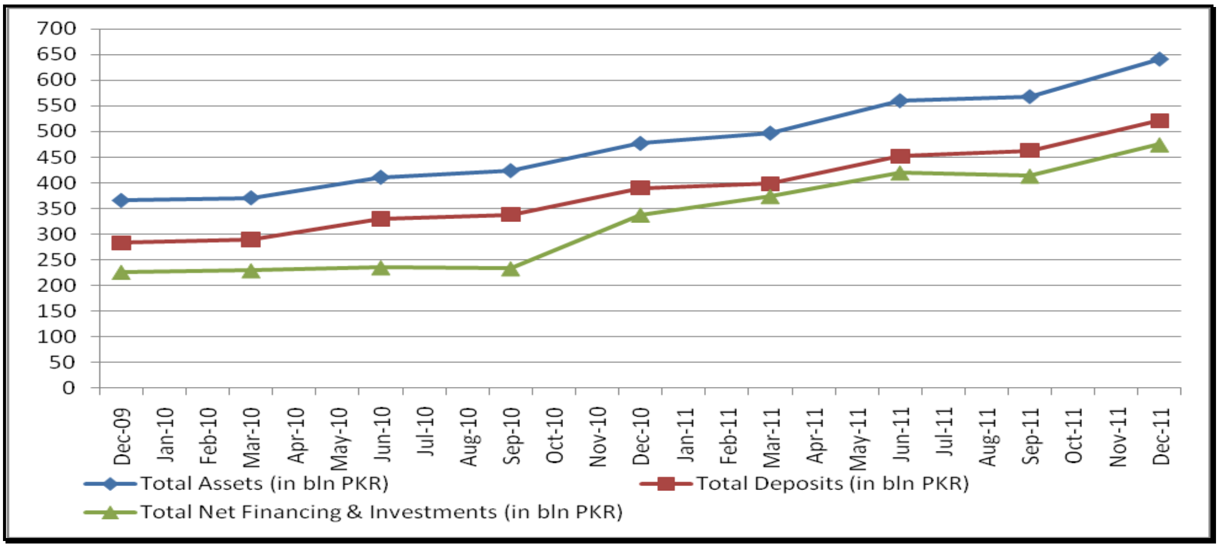
[1] Salman Ahmed Shaikh is a researcher in Islamic Economics. He is pursuing PhD in Islamic Economics at IBA, Karachi. He also serves as a Research Associate & Lecturer at IBA, Karachi. He has authored 12 papers and a book on Islamic Economics in past.

In Pakistan, there are 5 full-fledged Islamic banks operating and 15 conventional banks with Islamic banking branches. The growth in Islamic finance industry has been consistently in double digits. Figure 1 depicts the growth trend during the last three years in Islamic banking total assets, deposits and net financing and investments in Pakistan.

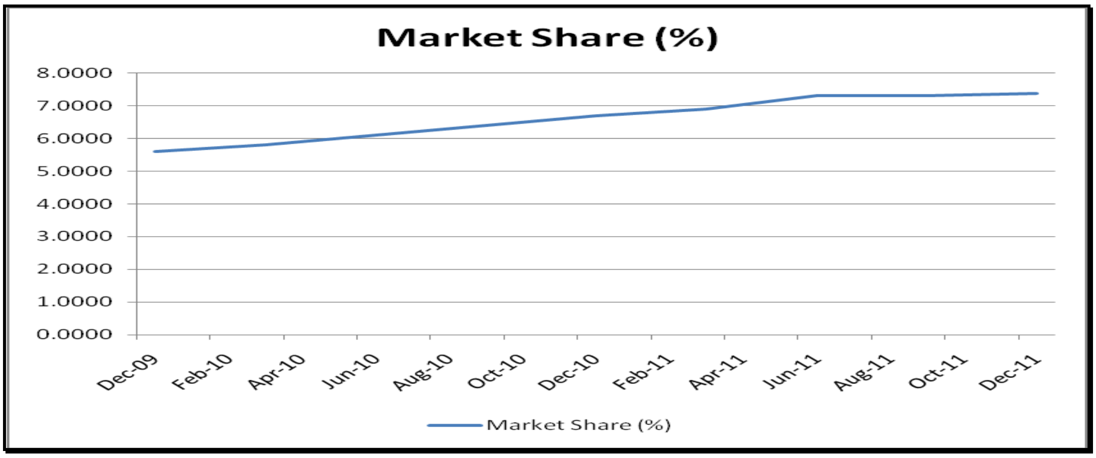
Figure 1: Growth Trend in Assets, Deposits & Net Financing



Source: Islamic banking Bulletin, SBP, Various Issues

The share of the Islamic banking industry in the banking system of Pakistan has risen to over 7 percent in 2011 from just 0.5 percent in 2002 as can be seen in Figure 2.

Figure 2: Market Share of Islamic Banking Industry



Source: Islamic banking Bulletin, SBP, Various Issues

But, on the other hand, Islamic banking industry mostly uses KIBOR linked financial contracts which are akin to debt financing than the more preferable participatory modes of Mudarabah and Musharakah. Hence, same state of affairs in this regard from past to present does not show a promising picture from the viewpoint of having an egalitarian, Islamic principles and value based distinctive financial system.

There are some economists who implicitly opine that the participation in current financial globalization is important for growth of Muslim economies and even if, Islamic banking has some unresolved issues and complications with regards to Shariah compliance, the participation in global financial system is imperative. Zakariyah (2012) argues that the effect of refrainment of Muslims from participation in the current global economy, especially, property investment particularly in the West at large, will put Muslims in the desecration of wealth.

This perspective does not take notice of perils of fractional reserve system and fiat currency on economic instability, persistent economic crisis and its effects on development. Indeed, openness in terms of trade and increased documentation and linkage is vital, but it is different from adopting a particular monetary system designed to perpetuate interest based financial intermediation.

2. Time Value of Money & Islamic Finance

Islam allows investment for trade in which investment goes through the entire process of a commercial productive venture and which involves risk taking at each stage. In such a venture, any reward on investment is strictly dependent upon the outcome of the commercial venture. The profit for the entrepreneur strictly depends upon the actual profit realized after taking market risk including price risk. It does not depend upon time and amount of investment made.

Time value of money is the basis of interest. As per Islamic standpoint, time value of money is the problem for the investor to avoid keeping his money idle and to avoid forgoing the use of money that may bring positive value to his investment. However, it does not mean that the investor can demand a fixed increase over a sum of money lent as the cost of using money.

As per Islam, money has to be converted into capital and the capital must take entrepreneurial risk and only then, the capital can be rewarded with sharing in actual profits arising from the commercial venture.

In principle, there is no disagreement on this above mentioned principle between theorist and practitioners, but, as a matter of fact, all debt based financing modes are currently priced using interest based indexes as a benchmark. For all practical purposes, this has tried to restore time value of money or tried to provide a convenient alternative to time value of money in which minimal changes in payoffs and timings of payoffs occur.

All such product vetting and engineering must have taken into account the fact that entrepreneurial risk is the cornerstone of permissible earnings from any allowable business venture in Islam. This risk can only be eliminated at the cost of compromising the basic distinctions of Islamic economic principles.

3. Use of Trade and Lease as Financing Modes

It is an empirical fact that Islamic banks prefer to offer debt related products (Ismail, 2011). In all debt based financing modes, there are two legs of transactions. In one leg, the bank purchases the asset which the client needs from the vendor. Often, client is made the agent to purchase that asset on bank's behalf. In second leg, the bank sells or leases the asset to the client. Before the Islamic bank purchases the asset in first leg, it asks the client to give a unilateral undertaking. Through this, the client undertakes to purchase the asset from the bank in second leg of the transaction.

Unilateral undertaking which is legally binding enables the bank to completely avoid the price and market risk in Islamic banking. Islamic bank locks the price and by way of legally enforceable unilateral undertaking, it also binds the customer and that is all done before the bank even thinks about purchasing the asset, let alone having an inventory of tradable assets.

Fact of the matter is that bank does not commit a single penny unless it has taken a legally enforceable unilateral undertaking from the customer. Through this, the bank obliges the customer to agree to the quoted rentals or markup price (calculated from the same present value formula).

It is argued sometimes that higher price in credit sale was permissible and was practiced in Arab in olden times. Various noted scholars are quoted in support of this viewpoint (See Usmani, 2007).

But, the question is that where and how the Islamic bank takes on risk. By monetizing its funds using asset backed financing provision, the Islamic bank all of a sudden becomes seller of every Halal type of asset without bearing any market or price risk and without managing and keeping any sort of an inventory or warehouse.

Let us see what happens if we lease car from an Islamic bank. The rent will be more if we were to lease for a short period than for a long period. Why is that so?

Islamic bank basically amortizes all its costs through rentals. It is acting as a financial broker looking to amortize an investment made. For the same asset or property, the bank will charge higher rentals for short term lease and lower for long term lease. It is because the bank is willing to amortize all costs and acting as a financial broker.

Islamic banks being financial intermediaries are using the same interest based index as benchmark for pricing. Already, they are not charged General Sales Tax (GST) on their sale of assets to clients in second leg of transaction and the Government by not levying GST regard an Islamic bank as a financial intermediary and not as a trading concern.

Most definitely, trade for profit and lending for interest has an ocean in between. They are different from all perspectives, i.e. legal, economic, social and even with regards to psychological implications and effects. But, when Islamic banks use the concept of trade and lease, they use it in a manner that raises questions about the substance behind these transactions. Indeed, as this paper argues, it seems that Islamic bank does not in a practical sense take on market or price risk meaningfully.

It is very important to appreciate that the viewpoint of scholars quoted in support of the argument that higher price in credit sale is allowed and was practiced, did not involve any financial intermediary doing the transactions principally during those times. If a genuine and established trader or seller sells on cash as well as on credit and has been in the business taking on price and market risk of the business in its normal course and charges a higher selling price in "some" of the credit transactions, he still takes on all relevant risks required on the part of trader.

What an Islamic bank does is to take only this permissibility of charging higher price in credit transactions as a support for its operations, then monetize the asset and purchase it only when the customer had signed an undertaking which enables the bank to earn the level of profit which is not representative and reflective of average profits on the sale of such assets. Rather, the Islamic bank earns a level of profit which the conventional bank earns. This is ensured by making KIBOR/LIBOR as a benchmark and lamentably, this is not the end of the story. With higher banking spreads than conventional banks, Islamic banks in Pakistan earn even more profits from their clients and share lesser with their depositors, on average.

Permissibility of trade and lease in Islam in not questionable, but practices of Islamic banks which seem to avoid business risk altogether in a systematic way are indeed questionable. Apart from Murabaha Muajjal in which the Fiqh basis can be questioned and has been questioned by noted scholars as well, let us just consider Ijarah, Salam and Istisna for the clarification of the issue. These contracts are understood and approved by a majority and these contracts had been mentioned in several Ahadith as well.

Again, same question arises that how an Islamic bank takes on business risk in these contracts. In Salam, before paying the Salam price, if a unilateral undertaking is taken from a third party for a parallel Salam or in Istisna, if the client is made the agent and sometimes a guarantee is also taken from him to provide surety that the third party will provide payment on time in credit sale of Istisna commodity, how come the Islamic bank is taking on the business risk?

Similarly, sale and lease back transaction in house construction finance and in commercial finance is also a transaction in which Islamic bank purchases the asset without any need of its own from the same customer to whom the asset is leased subsequently. The lapse of at least one year period between sale and lease recommended by Shariah scholars is also not a sufficient justification since the Islamic bank takes undertaking from the client beforehand which enables the bank to lease the asset subsequently after one year.

Country risk, political risk, currency risk, default risk, credit risk, interest rate risk etc are taken by conventional banks as well. The relevant risks which differentiate lending for interest and trade are the price risk i.e. sale price may not cover costs and the market risk i.e. goods/services may remain unsold. It is interesting to study whether the principle of **Al-Khraj bil Dhaman** and **Al-Ghanum bil Gharam** (One is entitled to a gain only if one agrees to bear the responsibility for the loss) are violated in Murabaha and all prevalent Islamic finance debt based financing contracts where unilateral undertaking which is legally binding as well links two sales contracts or one sale and the lease contract to mitigate price and market risk.

Masri (2002) having this similar concern writes:

> **"Some modern jurists have moved such a unilateral promise (wa'd) from the category of voluntary offer (tabarru'āt) to that of commutative contracts, (mu'awadāt), so as to replace the contract. That is because these proponents have found that (Murabaha, i.e., a resale**

contract with specification of gain (cost plus original price) is not permissible, since it falls under the sale of goods that are not in one's possession (the goods are not in the bank's possession). So, they replaced the contract with the unilateral promise (wa'd), that is to say, they made the contract a unilateral promise (wa'd). Had they stopped at that point, and had the unilateral promise (wa'd) remained non-binding, there would not have arisen any problems; but, in fact, they went on to say, and herein lies the gravity of their position: we will make the unilateral promise (wa'd) binding—and so they went a long way in elaborating, amplifying, dissecting, and subcategorizing, until they filled people with the fear of not fulfilling a unilateral promise (wa'd) so much so that the binding unilateral promise (wa'd), which for them is permissible, came to replace the contract which is proscribed by Islamic law. Is this admissible? And is there any difference in this case between the contract and the binding unilateral promise (wa'd)?"

He further writes:

"The consequence of such a direction in adopting rulings is, in my view, to make "Islamic" banking operations conform to traditional banking transactions and render them even more complicated, obscure, and costly."

Then, in conclusion, the noted scholar writes:

"In summary, it is inadmissible for the unilateral promise (wa'd) as an alternative to a proscribed contract, such as selling goods that are not in one's possession, to be binding, because a binding unilateral promise (wa'd) is analogous to a contract. Any views for making it binding upon both or either parties, explicitly or implicitly, by virtue of a Memorandum of Understanding (MOU), a sideline agreement, or any other circumvention, are not founded on any legitimate basis."

Chaudhry (2006) sharing the same criticism stated that the capitalist globalization is deep in the agenda of Islamic commercial financial institutions. To pursue this goal, a narrow juristic interpretation of the Shari'ah is followed, leaving aside the Tawhidi core.

To conclude this section, let us now see what the respected scholar Maulana Mufti Muhammad Taqi Usmani sahab wrote in some of his recent writings. In his article, 'New Steps in Islamic Finance', the respected scholar writes:

> **"…One must not forget that these instruments are not modes of financing in their origin. They are in fact some forms of trade that have been modified to serve the purpose of financing at initial stage as secondary and transitory measures. Since they are modified versions of certain forms of trade, they are subject to strict conditions and cannot be used as alternatives for interest-based transactions in all respects. And since they are secondary and transitory measures, they cannot be taken as final goal of Islamic Finance on which Islamic Financial Institutions should sit content for all times to come. It is a matter of concern for a student of Islamic finance, like me, that both these points are increasingly neglected by the players in the field, and especially by the new-comers in the industry."**

Furthermore, in his book, 'Introduction to Islamic Finance', the respected scholar, Maulana Mufti Muhammad Taqi Usmani sahab 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." (p. 72)**

4. Reasons for Prohibition of Interest

Some respected scholars representing current Islamic banking movement argue against the viewpoint that interest is prohibited solely because of its economic evils. Before the advent of Islamic banking, there was no such confusion and misunderstanding regarding why interest is prohibited. In fact, Islamic Economics literature was perhaps solely devoted to explaining just the logic and reasons behind prohibition of interest.

What happened after the advent of Islamic banking and finance? As a matter of fact, it is growing at around 15 percent and regarded as the most profitable industry in finance nowadays and its profit potential can be gauged from the higher banking spreads.

Explaining the verse 275 of Al-Baqarah, some respected scholars argue that the verse was revealed to clarify the difference between credit sale (of the type which is used today in Islamic banking) and Riba (Usmani, 2010).

There is a huge difference between interest based economic activity and trade. If there had been a little difference, Allah would have given the reason for its prohibition in place of the verse in which Allah has declared the advocate of interest as the one who has become mad by the touch of the evil (Al-Baqarah: 275). Rather than being derisive here, arguments against interest will have been given by Quran. But, it was not needed because the people understood what interest was and what was trade.

Respected mainstream scholars behind Islamic finance movement while explaining verse 275 of Al-Baqarah opine that if this and similar injunctions do not become clear to the human mind, it should not become a reason for argument and disbelief (Usmani, p. 172, 2009). Also, please see 'Muarif-ul-Quran' by respected scholar Mufti Muhammad Shafi Usmani Sahab, Volume 1, page 684.

It is to be noted that these esteemed and respected scholars had also explained at various places the rationale behind prohibition of Riba. But, 'Muarif-ul-Quran' does not mention that the word 'Bai' in verse 275 of Al-Baqarah refers to the credit sale only. Maulana Taqi Usmani sahab however has explained this context in his exegesis of Quran as well as in his book 'Ghair Soodi Bainkari' [Interest Free Banking].

Now, if one reads the verse 275 of Al-Baqarah, it seems that Allah is criticizing using the very argument that no sane person can equate trade with Riba. If one does, then, he is like someone who has become mad by the touch of the devil. Following is the translation of the verse under discussion.

> **"Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while Allah has permitted trade and forbidden interest." [Al-Baqarah: 275]**

If argument of interest not prohibited due to any explicit, logical and rational reason is taken; then, we ought to believe that Allah has declared an activity to be like waging War with Allah and Prophet (pbuh) without making it clear why interest is prohibited!

Alternatively, if the explanation of the proponents of Islamic banking for verse 275 of Al-Baqarah is taken, then, it seems very strange that if no apparent difference exists in the economic effects of the two transactions i.e. credit sale (of the type used in Islamic finance) which resembles Riba and Riba itself, why would someone indulge in Riba if the same level of profit can be achieved through a credit sale which only resembles Riba. No one should and now conventional financial institutions are the leaders behind promoting Islamic finance industry and their number is twice more than full fledged Islamic banks operating in Pakistan.

Secondly, how strange it would be to assume that Allah would punish taker of Riba so severely, while from the economic standpoint, the one who undertakes a credit sale transaction (the financial intermediary) which resembles Riba would have earned the same level of profit or in fact more with higher banking spreads!

5. Islamic View on Debt Based Financial Intermediation

Islamic principles never encourage one to become indebted unless it is necessary. Following Ahadith show the viewpoint of Islam on debt creation, especially while it is beyond one’s capacity to repay.

Prophet Muhammad (pbuh) said:

“O Allah! I seek refuge with Thee from sin and debt.”

[Sahih Muslim, Book 4, Hadith 1218]

The Prophet Muhammad (pbuh) said:

“After the grave sins which Allah has prohibited, the greatest sin is that a man dies while he has debt due from him and does not leave anything to pay it off, and meets Him with it.”

[Sunan Abu Daud, Book 22, Hadith No. 3336]

Following supplication is related to the Prophet Muhammad (pbuh) for salvage from debt:

"O Allah! I seek refuge in You from all worry and grief. I seek refuge in You from incapacity and slackness. I seek refuge in You from cowardice and niggardliness, and I seek refuge in You from being overcome by debt and being subjected to men."

[Abu Daw'ud, in Fiqh-us-Sunnah, volume 4, #131]

But, the currently practiced Islamic finance contracts used widely are predominantly based on debt based financing than equity financing.

6. Status of Preferable Financing Modes in Practice

Mudarabah is considered to be one of the most preferable modes of Islamic finance both by earlier and contemporary jurists and Islamic scholars. Ibn Taymiyyah observed: "One who deliberates on the basic principles would easily conclude that *Musaqat, Muzara'ah* and *Mudarabah* are nearer to justice than hire." (Fatawa, Vol.20. p.356).

Maulana Taqi Usmani (2004) in his book "Introduction to Islamic Finance" stated at least 5 times that Mudarabah and Musharakah are ideal modes of financing on page 12, 17, 72, 107 and 164 respectively.

Khan & Mirakhor (1987) commenting on the preferable nature of Mudarabah commented as follows:

> **"Even though in practice the role of profit-sharing and partnership is very small at present, they continue to dominate the theory of' Islamic banking. They are regarded as the norms towards which practice should and would, eventually gravitate." (p.185-199).**

But, still the share of equity financing and Qarz-e-Hasan is disappointing in total financing portfolio of Islamic Banks as can be seen in Table 2.

Table 2: Share of Equity Financing & Qarz-e-Hasan in Total Financing

Period	Share of Equity Financing & Qarz-e-Hasan (%)
Dec-11	2.5500
Sep-11	2.9100
Jun-11	2.9100
Mar-11	3.1700
Dec-10	3.0500
Sep-10	1.4200
Jun-10	3.9000
Mar-10	1.9700
Dec-09	2.1400

Source: Islamic Banking Bulletin, SBP, Various Issues

With Murabaha as an alternative, profitable companies will not opt for Mudarabah/Musharakah because they will not like to share profits. Instead, they would go for cheaper way of sourcing funds i.e. debt financing. Less profitable companies will want to go for Mudarabah/Musharakah, but bank as conservative financial institution will not take risk with these companies. The argument that Mudarabah/Musharakah financing is not possible due to lack of authentic documentation and trust level is also very weak.

Islamic banks operating in developed markets (it is to be noted that the developed countries are the hub of Islamic banking) where such problems are not found have also not gone for Mudarabah/Musharakah financing. As a matter of fact, Islamic banks do not want to take market and price risk. Default, credit, political, exchange and other risks are also taken by conventional banks. If Mudarabah and Musharakah are deemed ideal alternatives by Islamic banking experts and scholars favoring it; then, they would have been better off entering into investment banking before they entered into commercial banking.

7. Form Versus Substance Debate

With debt based modes of finance used predominantly and priced with same interest based benchmarks, it seems that practiced Islamic banking is far removed from the ideals of Islamic economic principles.

One may in fact go on to say that it is in fact doing harm to the objective of promoting Islamic economics by mimicking conventional banking products and using the same paradigm to make these products somehow conform to Islamic legal framework.

There is limited originality in product structures and most importantly, they do not hit the roots of the evils of interest based system and Capitalism. If interest was prohibited due to exploitation as explained by Quran, then, how Islamic banking having higher spreads than conventional banking and using primarily the debt based modes of finance, justifies avoiding exploitation and providing anything substantially different from conventional banking system.

Below, we strive to see how Allah in Quran sees form versus the substance debate. If there is guiding light from Quran on a particular issue, we must submit to it and render all other Fiqh literature and our opinions secondary to it.

Jews were given an order to slaughter the Cow. Instead of doing it, they started asking questions about the 'form' of the Cow to be slaughtered. Instead of encouraging their questions, Allah criticized their 'form centric' approach. Following is the passage in Quran which reports that event:

> **"And (remember) when Musa (Moses) said to his people: "Verily, Allah commands you that you slaughter a cow." They said, "Do you make fun of us?" He said, "I take Allah's Refuge from being among *Al-Jahilun* (the ignorants or the foolish)." They said, "Call upon your Lord for us that He may make plain to us what it is!" He said, "He says, 'Verily, it is a cow neither too old nor too young, but (it is) between the two conditions', so do what you are commanded." They said, "Call upon your Lord for us to make plain to us its color." He said, "He says, 'It is a yellow cow, bright in its color, pleasing to the beholders.' "They said, "Call upon your Lord for us to make plain to us what it is. Verily to us all cows are alike, And surely, if Allah wills, we will be guided." He [Musa (Moses)] said, "He says, 'It is a cow neither trained to till the soil nor water the fields, sound, having no other color except bright yellow.' "They said, "Now you have brought the truth." So, they slaughtered it though they were near to not doing it."**

In Chapter Hajj (Verse 37) while describing the essence of 'Qurbani', Allah said:

> **"It is neither their meat nor their blood that reaches Allah, but it is piety from you that reaches Him. Thus have We made them subject to you that you may**

magnify Allah for His Guidance to you. And give glad tidings (O Muhammad pbuh) to the *Muhsinun* (doers of good).”

When Allah ordered the Muslims to change the direction of prayers, this was not acceptable to non-believers. Allah categorically said that directions do not matter, all directions are for Allah, what Allah wants to test is whether humans follow their own desires or Allah’s commands. Here again, we see that form is of little importance, what matters is the substance.

Say, (O Muhammad [pbuh]) ‘To Allah belongs both, east and the west.’ (Al-Baqarah: 142)

Islamic bankers and scholars must remember the behavior of 'Ihl-e-Sabbath' and Allah's verdict on that behavior. People of Aylah were prohibited from fishing on Saturdays. The fish used to come only on Saturdays since Allah was testing their obedience. But, they made a trick to catch the fish on the Sabbath. They fixed their fishing nets and ropes on Friday so that fish get into the nets on Friday and they could catch them on Sunday. They were considered disobedient by Allah on this behavior and they were doomed.

8. Analysis of Logical Arguments

The proponents of Islamic banking repeatedly try to give some logical answers to support the case of Islamic banking and argue that end result of many activities could be same, but their interpretation with regards to Halal and Haram could still be different. Hence, if in Islamic banking, the end result in terms of cost and profit to the bank seems similar, it is not much of a problem. These logical arguments are analyzed briefly.

It is said that a McDonald burger in west and east may taste same, but one may be permissible i.e. halal and one may be prohibited i.e. Haram if it is prepared from the meat of the chicken which was not slaughtered in the prescribed manner. It is a weak argument. The prohibited burger is not prohibited due to the taste. It is prohibited because the prescribed manner of slaughtering is not followed to obtain the meet for the burger. The reason of prohibition is not biological (taste), it is psychological i.e. Allah has permitted to take the life of an animal, but humans must remember that it is Allah who has permitted them to take the life of an animal for food and must utter words which signify this understanding.

It is argued in some promotional programs and related literature that pre-marital and post-marital sex may give same utility, but one is permissible and the other is not. Here again, the reason for prohibition of pre-marital sex is not biological or with regards to difference in utility, but it is social. Islam treasures family system and wants to protect its sanctity at all cost. The very structure of the family system rests on limiting free sex and confining it only to marital relations. Else, from a social point of view, humans would be no different than animals.

9. Reflections on Islamic Banking Operations

Asyraf (2008) conducted a research based survey which revealed that respondents regard Islamic banking as an institution that should uphold social objectives and promote Islamic values towards their staffs, clients and the general public. Other factors perceived to be important include contributing to the social welfare of the community, promoting sustainable development projects and alleviating poverty.

Growth in Islamic banking is exemplary, but what is little disturbing is the fact that Islamic banking could not live up much to its initial promise and commitment to contribute towards equitable distribution of resources by offering distinct financial products.

Much of the financing products currently offered are in effect, debt based financial contracts which are priced using the same interbank interest rate benchmarks.

What had been even more disappointing and surprising is the fact Islamic banking spreads - the difference between average financing and deposit rates - have been constantly higher than the overall banking spreads in Pakistan during the last three years as shown in Table 2.

Table 2: Comparison of Banking Spreads

Period	IB Spreads	Banking Spreads
Sep-11	8.40%	6.70%
Jun-11	8.80%	6.90%
Mar-11	8.40%	6.90%
Dec-10	7.10%	6.80%
Sep-10	7.70%	6.80%
Jun-10	7.70%	6.90%
Mar-10	7.70%	6.60%
Dec-09	7.00%	6.60%

Source: Islamic Banking Bulletin, SBP, Various Issues

Table 3 below confirms that Islamic Banking Spreads (IBS) are more than conventional Interest Rate Spreads (IRS) at a statistical significance level of only 2%. Hence, for the population as a whole, we can safely infer that in recent years, Islamic banking spreads have been higher than conventional interest rate spreads on average. This result is despite the tremendous growth and exemplary low non-performing financing assets in Islamic banking in recent years.

Table 3: Equivalence of Means Test for Comparing Banking Spreads

Paired t test

Variable	Obs	Mean	Std. Err.	Std. Dev.	[95% Conf.	Interval]
ibs	9	7.911111	.2084629	.6253887	7.430395	8.391827
irs	9	6.766667	.0408249	.1224746	6.672524	6.860809
diff	9	1.144444	.1958678	.5876034	.6927723	1.596116

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     mean(diff) = mean(ibs - irs)                              t =   5.8429
 Ho: mean(diff) = 0                           degrees of freedom =        8

 Ha: mean(diff) < 0          Ha: mean(diff) != 0          Ha: mean(diff) > 0
 Pr(T < t) = 0.9998        Pr(|T| > |t|) = 0.0004          Pr(T > t) = 0.0002
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The so called asset backed nature of financing in Islamic finance deprives one to finance education, health, autonomous and necessary consumption. What it ensures is the rent seeking by Islamic institutions that insure the asset and add this insurance cost in the rentals and Murabaha price to make the receivable as secure as interest on loan. This is achieved by mitigating price, market and asset risk which is the basic distinguishing feature between trade and Riba.

Islamic financial institutions built their reputation and gained acceptance from masses having promised socio-economic benefits of an egalitarian financial system based on Islamic principles.

Islamic banking literature and speeches of the pioneers often used analogical examples which argue that the current system is 'first aid' treatment and though that does not bring any long term cure, but it is nevertheless all that can be done immediately to stop the disease from worsening.

But, the disease has been worsening and Islamic banks have largely failed to offer anything beyond 'first aid'. In fact, nowadays, rather than offering anything substantially different and beyond first aid, Islamic banks have surprisingly conceded that now the patient himself does not need anything other than the 'first aid'.

Now, Islamic banks have become banks for the rich elite in urban localities and for the businesses that want to expand their size through ownership of assets.

Imran & Mark (2011) found through a research survey that investment behavior is influenced by the degree of religiosity of the individual. It was found that Muslim investors also had 'Western style' wealth maximization objectives. Islamic banks through their advertising campaigns are promoting consumerism in society and they leave behind the Islamic virtues of *'Shukr' (thankfulness)*, *'Sabr' (patience)*, *'Tawakkul' (steadfastness)*, *'Infaaq'* (payment to charity), refraining from *'Israaf' (extravagance), 'hubb-e-maal'* (love of wealth) and *'hubb-e-dunya' (love of materialism)*. Instead of creating awareness about these virtues with their position as an Islamic institution or an institution working in conformity with Islamic rules and principles, what Islamic banks have been unable to do is to create awareness among the masses about the Islamic virtues mentioned above.

Islamic banks have no products for financing education, health, microenterprises etc. Their clients are mostly blue chip companies which can obtain financing from many other financial institutions as well. Often times, when these big-size companies take financing from Islamic banks, it is largely a favor to Islamic banks.

One can say that Islamic banks are commercial institutions and not charity based institutions. Yes, this would not have been too much disappointing had they conducted their operations with this proposition only.

The irony is that Islamic banks built up the case for Islamic banking and finance citing the prohibition of Riba from Quran and Ahadith, its evil consequences in life hereafter, benefits of Qarz e Hasan, fruits of participatory and equity modes of financing and then offered such products in practice and have persisted with it which has created a happy and healthy commercial co-existence and long term complimentarity between conventional and Islamic banking.

Ismail (2011) stated that recent growth experience and product innovation directed towards coming up with more sophisticated products using debt based structure exhibit that growth has taken more precedence over Shariah compliance in letter and spirit.

Regarding the economy wide effects of Islamic banking, we must note that the Islamic banks use predominantly the debt based modes of financing and price these products using interest based benchmarks which are used by conventional banks. This done even on a large scale is going to provide no better results to the economy than the conventional banking at present or even in future.

Almost 100% of all the financing products of Islamic Banks are linked with interest based benchmark, whether it is Diminishing Musharakah, Murabaha or Ijarah etc. Hence, all of the "debt based modes of financing" priced using interest based benchmark are equally less ideal.

Islamic banking spreads are higher than conventional banks in Pakistan. Islamic banks may defend themselves by saying that they:

1. Finance companies that have higher risks.
2. Provide more consumer financing which has higher risks.
3. Have high cost of deposits.
4. Have fewer avenues for parking liquidity.
5. Have high operating expenses etc.

These justifications may seem valid and reasonable, but if we think deep, there are problems with this line of reasoning.

Regarding the possible justifications for higher spreads in Islamic banks, it must be noted that Islamic banks always provide ‘secure’ financing. They finance assets and have legal claims on the assets if the client does not make payments on time. Secondly, since their non performing loans are very low, it signifies that they do not finance riskier companies than conventional banks. Hence, their high spreads on this premise are not acceptable.

Furthermore, Islamic banks do not provide consumer loans in the category of credit cards and unsecured personal loans. These are products which carry high rates of interest. Hence, their product mix while not having such high-priced products must therefore lead to comparatively lower spreads which is not the case.

Finally, Islamic banks had been providing liquidity to the conventional banks using commodity Murabaha. Through this, they have been able to invest their surplus liquidity. But, the investment with conventional banks leads to some very unfortunate outcomes. Islamic banks take deposits of customers after convincing them about Islamic banking. But, when they pass on these deposits to conventional banks, the conventional banks provide interest based loans from these funds. Hence, this is an unfortunate state of affairs.

Concluding Remarks

Islamic banks after having spent a decade of Islamic banking operations in Pakistan have to reflect on answers to the following points:

1. How justified are high Islamic banking spreads (difference between average financing and average deposit rates) which have reached

8.40 percent and are one of the highest in the world and more than two percentage points higher than conventional banks in Pakistan?

2. How justified is the argument to seek special privileges from the regulators when Islamic banks use the same benchmark rate, but the difference is that their spreads (margins) are even higher than conventional banks?

3. How do they justify their position and analyze their performance on social and egalitarian grounds when most of their products are priced using the same benchmark of the conventional banking industry, which is KIBOR?

4. Equity financing is regarded as the most ideal mode of financing in an Islamic economy by Islamic scholars. Why it is hardly used in financing the clients with a contribution of less than 2 percent in total financing?

5. Trust and documentation problems did not hinder 700 companies to get registered on Karachi Stock Exchange while thousands of public limited companies are operating in Pakistan as well. Why Islamic financial institutions could not help support more IPOs either through investment banking operations or alternate institutional structure?

6. Lastly and most importantly, they must reflect on what was the real reason for prohibition of Riba? If it was exploitation, then should an alternate system claiming to be founded on Islamic principles not differ in any substantial way in terms of cost? Unfortunately, if there is any difference, it shows that Islamic financing schemes are costlier than conventional.

Going forward, it is hoped that after having completed one decade of successful operations of Islamic banking and exhibiting exemplary growth in commercial sense, Islamic banks will look towards increasing their outreach to the poor masses and start using more equity based modes of financing which help improve their image and bring some fruits of Islamic economic principles.

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