Kazim Alam speaks to Dr Ishrat Husain about the issues surrounding the transition of Pakistan’s banking system into a fully Sharia-compliant model by the end of 2027. Currently Chairman of the IBA’s Centre for Excellence in Islamic Finance, Dr Husain has played a pivotal role in establishing Islamic banking in Pakistan as a two-term governor of the State Bank of Pakistan (SBP).

KAZIM ALAM: Is the target of complete conversion from conventional to Islamic banking in five years achievable?
ISHRAT HUSAIN: There are certain issues that need to be settled, and the government and the SBP have formed a committee to look into them. If they are able to find the right solutions, it will be entirely possible to transition to Islamic banking within the five-year timeframe. If not, they will have to go back to the Federal Shariat Court and list the constraints. For example, the international financial system is not attuned to the Islamic system and this is going to be a major challenge.

KA: Should the government or the SBP be forcing one model of banking on all industry players?
IH: When, in the light of the court decision two decades ago, we started Islamic banking, we said we would follow a parallel track. The banks that were prepared to have full-fledged Islamic banking services through subsidiaries and windows could opt for that route. The remaining banks could either convert at their own pace or if they were unwilling, they could continue with conventional banking. This was the start of Islamic banking in 2001 when I granted the first licence to Meezan Bank. In the last few years, the pace towards Islamic banking has accelerated and the rate of growth among Islamic banks is much higher compared to the conventional banks. Furthermore, more so than ever before, borrowers are in favour of Sharia-compliant products. So I am more confident today than I was earlier that Islamic banking will dominate banking sooner rather than later. Having said this, I think we should allow the banks to reach that transition point at their own pace. Faysal Bank (FBL) is a good example. It took them four to five years to switch to Islamic banking. The onus is on the banks and their owners and managers rather than on the regulators.

KA: Are you satisfied with the pace of progress so far?
IH: Two decades ago, my expectation was that Islamic banking would become integral to financial inclusion. Corporates, high net worth individuals, trade financing – all these segments were already served by conventional banking. What was missing was the ability of the SMEs, small and medium farmers, low-cost housing and the disadvantaged regions of the country, to access financial instruments. Islamic finance, rooted as it is in the concept of equity, should have been the prime engine towards this shift, but this has not been the case. Islamic banks are still mimicking what conventional banks are doing to the extent that they have not made any substantive progress as far as financial inclusion is concerned. I am very disappointed.

KA: Islamic banks say that they are constantly dealing with liquidity management problems and that there are not enough investment avenues to park the deposits they raise.
IH: The only thing they complain about is the lack of short-term liquidity management tools to park their excess reserves. However, if you are in the business of intermediation, your surpluses should form a very small portion of your assets as opposed to the current practice where they park 60 to 70% of their assets as loans to the government. Investment-to-deposit ratios (IDRs) are quite high for conventional banks because they buy Pakistan Investment Bonds (PIBs) and treasury bills, but similar instruments are not available to Islamic banks, except Sukuk (Islamic bonds). My view is that their asset-to-deposit ratios (ADRs) should be in the neighbourhood of 70 to 80%, which will make their excess surpluses not that big. The government has now issued a calendar for Sukuk which will enable Islamic banks to park their excess reserves easily.

KA: What should the government do with the existing stocks of debt that are conventional in nature?
IH: The treasury bills are of three and six-month tenors, and can be replaced quickly with an instrument of short-term liquidity. As for PIBs, the government should not roll them over; it should substitute them with Sukuks of that particular duration as and when they mature.

KA: How should conventional banks convert their operations?
IH: From my understanding of FBL’s conversion, the major difficulty is not from borrowers who are more willing to opt for Islamic banking substitutes. The major problem is from the banks’ boards, owners, management and staff – their lack of knowledge and the fear of the unknown. Now, with FBL, we have a case study that we can use as a prototype.

KA: How would a conventional bank convert a housing loan for example to an Islamic product?
IH: It will have to seek advice from its Sharia board. Islamic banking offers diminishing Musharaka (as a substitute for typical housing loans). How a bank tailors and converts a housing loan into a diminishing Musharaka is both a Sharia and legal/structural issue.

KA: Do banks have the HR to deal with the transition?
IH: Right now, only 20% of the entire banking assets are Sharia-compliant. This means that 80% of the people working in the industry have no exposure to Islamic banking. This is a service industry. It is an industry where intellectual capital is used. Conventional banks have no sense of commitment, but the prerequisite for an Islamic bank is that it should be committed to doing business the Islamic way. We could have a multiplier effect if all the universities in Pakistan were to adopt a core curriculum and the pedagogical tools to equip students with an understanding of Islamic finance. Students may not go for a full Master’s programme in Islamic banking and finance, but if they do MBA degrees, with some exposure to Islamic finance along with some hands-on experience, we may be able to fill that gap. There is a need for coordination between the SBP, the Ministry of Finance, the Higher Education Commission and universities and colleges to develop an actionable plan. I don’t see that happening right now. If they are serious about overcoming the HR problem, they will have to make a concerted effort.

KA: Are there any instances in which customers would lose out from the absence of any form of conventional banking? For example, what if someone wants a personal loan or a credit card?
IH: Innovation and looking at other experiences outside Pakistan will be critical. If you keep looking within the country, you may not be able to identify workable solutions. Many other countries have adopted Islamic banking and come up with innovations and new products and services. We should learn from their experiences. I am more inclined towards an outward-oriented strategy rather than an inward-looking one. I think Malaysia has found a way to provide credit cards under Islamic banking principles, although I am not sure about its underlying structure.

KA: How will the complete conversion to Islamic banking affect Pakistan’s relationship with international financial institutions (IFIs)?
IH: This is an issue that is going to be quite difficult. IFIs are not going to change their way of doing business. We have to find a way to access those institutions. International Sukuk flotations will not be a problem. But we are very reliant on multilateral institutions, like the World Bank, the IMF and the ADB. I am not sure whether our Sharia scholars will permit a two-track approach, whereby we can continue borrowing from multilateral institutions on their terms and follow the Islamic way in other cases. Given our dependence on IFIs, we will have to grapple with this problem. I would also like to highlight that our Sharia scholars are very well-trained in Islamic jurisprudence but have very

little idea of how modern finance works. For Ijtehad and innovation, you must have competence in both areas. There is a gap here and I think this gap is unlikely to be filled in five years’ time.