Islamic Finance Evolution, Transition and Transformation

I would like to divide my remarks this morning in three parts (a) the evolution of Islamic Banking (b) transition to December 2027 and (c) Transformation of Islamic Banking.

Since 2001 Islamic banking has grown from almost zero to acquiring a market share of 23% of total banking deposits and 38% in financing. In periods of stress, domestic as well as international economic disruptions, and uncertainty, Islamic banking has remained resilient, and financial soundness indicators have been robust. Islamic banks have contributed to financial stability with limited credit risk, strong liquidity, and capital adequacy indicators. In the last two years significant developments have taken place as Sukuks issued by the Government , the successful conversion of a conventional bank into a full fledged Islamic bank and the relatively higher growth of deposits in the conventional branches of the conventional banks has accelerated the pace of capturing the market share.

SBP has begun conforming legal, regulatory, and supervisory frameworks with international standards, including those of IFSB and AAOIFI.

The question as to the transition to complete Islamic banking regime by January 2028 can be addressed in two ways. All hands on the deck approach by the banks, regulators, policy makers should remove the remaining hurdles from the way to meet the time line target. MoF has, however, in its Post-2027 Strategy Paper identified ten key actions and milestones that need to be achieved for a smooth transition. I am quite sanguine that the MoF, SBP, and SECP would work assiduously to complete these actions.

In the event the organic growth does not permit the attainment of the goal by the given deadline there is a strong case to plead before the Supreme court to let the transition period be extended by a few years to complete the cycle of conversion. Such an approach would provide a solid footing for the future transformation phase where the absence of competition with the conventional banks would enable the Islamic banks to follow the letter and true spirit of Islamic banking.

My concern, which I want to share with this distinguished group of practitioners, Shariah scholars, experts, and academics, is regarding the post transition or transformation phase where we would be completely Riba free economy . Whether we are prepared assuming that the transition is smooth to achieve Maqasid-al-Shariah in an exclusive Islamic Finance structure. So far, the track record of Islamic Financial Institutions during the last 25 years in meeting these goals has been , in my humble opinion, dismal and relatively worse than that of conventional banks. As we all know, Pakistan is faced with an increased incidence of poverty, rising income, regional and gender inequality, escalating unemployment and disguised unemployment rates particularly those of

graduates and erosion of purchasing power due to high inflation. Domestic savings rates are a meager 7%, and thanks to workers abroad, our national savings rate is 14–15%. That limits investment and thereby sustainable economic growth rate. If we judge this track record against the Maqasid-al-Shariah that prescribes financial inclusion, poverty alleviation, equitable distribution of wealth, economic development, entrepreneurship, social welfare, and sustainable growth, the Islamic Financial Institutions have failed to contribute to the achievement of these noble purposes. Our productive capacity does not meet the aggregate demand, and that spills over into increased imports, creating balance of payments crises and recourse to external borrowing. Islamic banks' share of total SME lending is 16% compared to 84% by conventional banks, and for agriculture it is only 8% a wide gap. Islamic banks are no different from conventional banks as far as exposure to holding government securities is concerned almost 60% of the assets. Will these banks and financial institution take a turn for better in the Transformation Phase.

I suggest that the contribution of Islamic banks once the transition is fully completed in accordance with the Supreme Court decision and the parallel banking system comes to an end should be evaluated by addressing the following questions

1. What proportion of disbursements is going for agriculture, SMEs, affordable housing, and women entrepreneurs?
2. Are Islamic capital markets financing long-gestation projects in infrastructure and large-scale manufacturing?
3. How much is the exposure of banks and NBFIs to government securities and to the private sector?
4. Are Islamic financial institutions using instruments of social finance such as Waqf, Zakat, Sadaqah, and Qarz-e-Hasna to provide educational opportunities to the poor segments of the population and adequate health care facilities in the rural areas?
5. Are female entrepreneurs being assisted both through financing and knowledge transfer by Islamic microfinance banks?
6. Are Islamic fintechs and digital banks expanding their outreach for financial inclusion?
7. Have they set up dedicated venture capital and angel fund facilities for promoting start-ups?
8. How much is mobilized by the NBFIs, DFIs, pension funds, Takaful, investment banks, REITs, housing finance companies, mutual funds, provident and endowment funds, Modarabas, and leasing companies?
9. Is the share of the non-banking sub-sector in total financial sector assets expanding?
10. What are the respective shares of Murabaha, Mudarabah, Musharakah, Ijarah, Istisna, and other Islamic financial instruments in financing?
11. Has a new benchmark been developed in place of KIBOR?
12. Are the Shariah standards and conventions still fragmented or harmonized and made uniformly applicable throughout the industry?

13. Do the depositors as investment account holders have a say in the governance of the banks?
14. Are the Microfinance Banks , Fintechs and Digtal banks reaching out to deprived districts, and innovative instruments for higher education of the talented students from poor families in addition to offering Qarz e Hasna?

My other set of concerns is the mammoth challenge of retraining of human resources—over 186,000 employees working in the conventional banks at present. The capacity of the institutions offering such training is quite limited and is not dispersed uniformly geographically. Have the SBP, NIBAF, CEIFs, and other centers of Excellence made arrangements for training these individuals in the next 12-24 months? Where would we get the trainers both in numbers as well as quality? Do we have enough qualified Shariah scholars to take up internal positions as well as man Shariah boards?

I use this platform to remind ourselves that we are so focused on the intermediate stage i.e. the transition that we haven't thought through the DAY AFTER when we would no longer have the excuse to blame the competition with the conventional banks for our shortcomings, weaknesses, inadequate thinking and lack of preparation. This does not absolve you from stepping up the efforts for December 2027 deadline but all of us collectively should also begin strategizing for the post transition period. The societal expectations from us are high and the detractors are sitting with snipers and drones to hit us if we are unable to bring the desired changes in the lives of Pakistani citizens .