

# **Transition to Islamic Financial System**

## **Unravelling the Knots<sup>1</sup>**

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I would like to commend IOBM for organizing this Conference at a critical juncture where we have to trace our path towards a fully fledged Islamic Financial Industry by January 2028.

Please allow me to be candid and frank as the purpose of my talk is to give a wakeup call.

Financial system is a vital component of the overall socio-economic system of a country as well part of international financial architecture in a globalized world. Transformation of a financial system in absence of complementary changes in the larger socio economic systems may not enable us to achieve the goals of Maqasid e Shariah. I would therefore like to draw your attention to at least a few pressing issues.

Judiciary and Legislature have done their job which was the easiest declaratory and directive giving a deadline for conversion of the entire financial system to become Shariah -Compliant.

The difficult part to make this transaction successful lies with the Executive Branch, the industry players, and the society at large. If adequate preparation work is not done and behavior and mindset are not altered the new system will become formally compliant but in my view substantively miss the spirit behind the conversion.

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What has the Executive got to do? I am aware that the Ministry of Finance and the SBP have formed various working groups for various aspects of the conversion. But are the remaining ministries, implementing agencies and provincial governments also working with the same commitment and passion. I am not aware but would like to be enlightened.

The present legal system, the laws, the procedures, the precedents, the training of lawyers and judges are historically and heavily tilted towards the common law inherited from the British. Contract enforcement and dispute resolution are lengthy, cumbersome, and costly. The Islamic Justice system is based on quick, inexpensive, and fair disposal of cases where the poor segment of the population is not hesitant or unable to access the judicial system with its multiple layers and convoluted appellate system. Is our legal system going to adapt itself in the next three years and conform to the requirement of Islamic financial system. I don't find any thought being given to this aspect of transformation.

Second, the present tax system is highly arbitrary, regressive, discretionary and penalizes honest and compliant tax payers. Evasion, cheating, falsification of records, fake receipts and invoices, over invoicing, under invoicing, misdeclaration are the outcomes of the present taxation system. Do we foresee any drastic change in the present system where equitable, fair and progressive taxation would be practiced. I don't see any evidence at present to convince me that we are moving in the direction that our taxation system would become compatible with the Islamic financial system.

Third, the regulatory burden on businesses and arbitrary discretionary process exercised by petty officials of labour, health, environment, building control, Sub-Registrars etc. has created an eco-system where bargaining to the mutual advantage of the regulatory and business takes place as a routine. As a result, Regulations are violated and the consumers suffer. Have we thought through

whether the present regulatory framework would facilitate conduct of transparent, honest transactions which is the corner stone of Islamic finance.

Coming to the society, we are all Muslims, and believe in life hereafter where we would be accountable for our deeds. If the fear of Allah Almighty has not deterred us from indulging in all malpractices, sell adulterated food, produce spurious drugs, weigh short, use substandard material for our buildings, swear to deliver goods on time but never do that, commit to make payments due for goods and services but keep on dallying and at times misappropriate that amounts, how do we expect them to change their behavior in the next three year just because we have switched to the Islamic financial system.

You very well know that trust is the basis of Risk sharing in Islamic Mode of Finance. If our borrowers maintain three sets of books-one for themselves, the second for tax payers and the third for their partners and investors don't you foresee that Islamic banking system would be faced with non-performing loans, erosion of capital and finally bankruptcy.

Next, the Islamic Financial services industry players themselves. The true spirit of Islamic finance is equity based risk sharing rather than risk transfer. We envisage that under the new Islamic finance system we would continue to depend on Ijara ,Istisna, salam or Murabaha or sale based transactions such as Musharaka with cost plus financing modes. Would these dominant modes allow us to reach out to the bottom of the pyramid—the poorest of the poor excluded so far from formal finance. We often talk about the close link between Islamic Finance and real sectors of the economy. The record for financing small farmers, small businesses etc. by Islamic banks and windows particularly those who don't have either assets or commodities to do the transactions has been dismal. What is our strategy under the Transformation Plan to contribute towards the goal of reducing incidence of poverty from 40 to 20 percent.

Are the banks ready to move towards Cash flow financing or program lending to provide access to small farmers or SMEs. Diminishing Musharaka is also a powerful instrument for promoting housing finance. Why is it that the existing Islamic banks and branches have not made use of this instrument to expand volumes of housing finance. Mortgage financing forms a miniscule portion of their portfolios. Are the IFI players equipped to manage risks arising from climate financing?

The Government has accelerated the issuance of Sukuks and would continue to do so in the future. Sukuk still form 10 percent of total outstanding domestic debt. How can the remaining 90 percent of PIBs and Tbills be converted into Islamic financial instruments. Have we got the requisite volume of assets to back up the Sukuks of that quantum? Is there a consensus among the Shariah scholars on Asset lite sukuks? What about the future debt issuance? Would the Islamic Banks be able to replace the conventional banks as the main conduit for the deficit financing of the Govt. Is deficit financing desirable or acceptable from the Shariah compliance perspective.

What about international correspondent banking relationships? Are these going to remain intact or undergo some metamorphosis under the new system. Do we understand the change that have to take place to stay part of the international system without disrupting the existing relationships.

My major concern is on talent acquisition, training and mindset changes of the staff who are at present working as conventional bankers covering 80 percent of the financial system and form the backbone of the system. How are we going to handle this gigantic task of equipping these thousands of employees with the understanding and the tools of applying Islamic Finance in their day to day work in the next three years. This is indeed gigantic as we don't have enough qualified trainers who are well conversant with Islamic jurisprudence and modern banking. After all it took Faysal Bank five years to go through this transition. What about Shariah scholars? Is there an adequate supply or pipeline of Shariah scholars who

would be able to form the Shariah boards for nearly two dozen conventional banks. If not, who is taking care of this?

The country faces huge challenges in human development. 25 million children are out of schools. Adult Literacy rate is 60 percent. Learning Poverty is rampant, stunting of children is 40 percent. Infant and Maternal mortality rates are high. We lag behind our neighboring countries in all social indicators. Technical and Vocational training enrolment is only 1 percent while the demand both domestic as well as International is quite high. Are the banks planning to develop new products or services to cater to this demand? Is the commercial IFIS working in tandem with Islamic social finance to use Zakat, Sadqah, Qarze Hasna & Waqf, charities, philanthropy, Microfinance, Fintech to tackle the challenges. Have they piloted any blended financing operation that can be subsequently scaled up to make an impact. We all have been talking about it for quite some time but no practical steps on the ground have so far been generated.

I do appreciate the Islamic banks are using the proceeds of penalty and fines for Qarze hasna and scholarships to deserving poor students but this has not been on a systematic collective basis. Is it permissible to use these funds for research and development, computer and science labs and equipment?

I have taken the liberty of the presence of senior govt officials, industry executives, academia and leading businessmen today to raise these daunting issues. I hope that you would at least begin to reflect upon them and then initiate action. January 2028 is not far off.