**[Islamic banking: the challenges ahead](https://www.dawn.com/news/1730160/islamic-banking-the-challenges-ahead)**

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WILL our economic and financial system be able to eliminate riba (interest) by December 2027, as ordained by the Federal Shariat Court? If the past is any guide, this time frame is almost impossible to adhere to. What are the challenges in transforming our economy into a riba-free system? How quick, or slow, has been the Islamisation of banks in Pakistan so far? To answer the latter question first, the first serious attempt to Islamise the banking system started in 2002, with the establishment of the Meezan Bank. Islamic banking assets then started to grow rapidly, but the share of Islamic assets in commercial banking grew very slowly. From zero per cent in 2002, to 8.2pc in 2012, to 19.5pc in June 2022 — the share has risen at an average speed of close to 1pc annum. If this share continues to rise at this pace, Islamic banking assets will surpass interest-based banking assets around 2052, when half our banking system would have been Islamised.

The actual speed of Islamisation will, of course, depend on how soon or otherwise we overcome the challenges. The primary challenge does not relate to interest-based banks becoming Sharia-compliant, but to the transformation of government, domestic and external debt to Sharia-compliant securities like sukuk. It is after such transformation that the banking and financial sector will find it simpler to move towards a riba-free system. This is easier said than done. The outstanding value of the federal government debt — domestic and external but excluding IMF debt and State Bank foreign exchange liabilities — was Rs47.8 trillion at end-June 2022. It has already crossed Rs50tr since then. Without the transformation of domestic debt, banking and financial institutions can’t become Sharia-compliant.

Though the transformation is not impossible, it is extremely difficult to achieve by 2027. Why? Because government borrowing from banks does not require any real assets from the federal government under the interest-based financial system. A riba-free system requires real assets against which the borrower can get Sharia-compliant financing from an Islamic bank. All financial activities, under the Islamic financial system, must be asset-backed. This is also one of the main differences between Sharia-compliant and interest-based activity. Linking the latter to a real asset is a direct, and not remote, exercise. Since financial activities, whether interest-based or Sharia-compliant, look similar, it confuses people into mistakenly thinking they are the same. Islamic financial activities are always different, despite appearing similar.

The actual speed of Islamising the banking sector will depend on how soon or otherwise we overcome the inherent difficulties.

The challenge of making government debt Sharia-compliant has been met only to the extent of about 5pc (of Rs 47.8tr) due to successful issuances by the government of ijara sukuk, that were valued at Rs2.3tr end-June 2022. This 5pc transformation was achieved over two decades. How many decades will our federal government take to transform the remaining 95pc of its debt is anybody’s guess. The government has its own genuine problems in undertaking this gigantic transformation. It does not have real assets (to the tune of Rs50tr) primarily because land is a provincial subject. As a result, most of the land in our country is owned by the provincial governments.

While we do not know how much land belongs to the federal and provincial governments, a simple internet search shows that 28pc of land in the US is owned by the federal government and 72pc by the state governments. Our federal governments have never undertaken an asset survey or census to estimate such ownership. What is the solution then? Can our Constitution be changed to make land a federal subject? If not, the federal government should devise ingenious ways of utilising provincial assets to issue further federal ijara sukuks. The nature of this challenge should be clear: that the envisaged transformation, while feasible, is going to take a long time.

A similar challenge relates to the State Bank. It owns about Rs6.1tr of PIBs, compared with its real estate assets of Rs165 billion. Once the government succeeds in converting its PIBs to sukuks, the central bank should exchange interest-based securities to become Sharia-compliant. To its credit, the State Bank has already devised a Sharia-compliant version of open market operations for injecting liquidity into Islamic banks when needed. A modaraba-based standing facility is also in place for injections, though mop-up facilities or OMOs are still awaited. The State Bank will be ready to implement its monetary policy in an Islamic financial system once both facilities are operational.

The pricing of Sharia-compliant securities is not a challenge now but will have to be modified once these securities surpass interest-based securities. Currently, the pricing (profit rate) of Islamic financial products is linked to interest-rate benchmarks (like the State Bank policy rate or Kibor). Sharia scholars have allowed this, presumably because in the formative stage of Islamic finance, independent pricing must take into account competition and profitability in the dominant interest-based banking sector. Once Islamic banking assets surpass interest-based assets, this reasoning will become invalid and the need for an independent Islamic finance benchmark profit rate will become inevitable. It is not difficult to imagine how ridiculous it will look if dominant Islamic securities continue to use an interest rate benchmark. Even now, this link creates a lot of suspicion about Islamic securities, although they are compliant with the Sharia.

Establishing this benchmark is and will be the State Bank’s responsibility. It is a challenging but doable task. Quarterly surveys need to be conducted to estimate the current profit rates in the real sector as well as in important sub-sectors like real estate for ijara sukuks, which are backed by land or property. The State Bank can then select an appropriate benchmark for future policy rates.

While the two-decade progress of Islamic finance in our country has been slow, it is still a big achievement, notwithstanding the prevailing scepticism about its authenticity. Scepticism stems from the inherent similarity between financial products on one hand and, on the other, the reluctance to probe existing structures of Islamic modes of financing which are thoroughly documented for each kind of transaction and truly transparent.

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