**Twin deficit**

BY N I Z A M U D D I N A R S H A D 2021-11-01

ISLAMIC banking currently accounts for 17 per cent of overall banking assets in Pakistan. Notwithstanding the talk about its double-digit growth, its share is not impressive, particularly for a Muslim country and given Islamic banking`s revival since 2002 when the first fully fledged bank was licensed. Why has our public not embraced it en masse when the choice is there? As in many other domains, faith may not invariably translate into practice. This dichotomy is neither unique to Islamic banking nor specific to Pakistan. In fact, wherever Islamic banks operate in parallel with conventional banks in a dual banking system, the share of Islamic banking is lower than 50pc in all but two countries.  
  
Myriads of factors may explain the lower penetration of this form of banking. For one, bank deposits are typically sticky, limiting the potential for a major shift from the well-entrenched conventional system to a relatively newer one. Then there are nonremunerative current accounts, presently around 36pc of our customer deposits; as these accounts earn no returns, their holders may find the distinction between conventional and Islamic banking immaterial, hence they continue with their existing banks.  
  
But there is also something deeper; it seems the growth of Islamic banking has been stymied by the twin deficit of `trust` and `understanding`. Consider the trust issue first. Many remain sceptical about whether Islamic banking is truly Shariacompliant. This may explain why some 90pc of the respondents in a 2014 State BankDFID study who viewed interest as riba and thus prohibited still largely banked with conventional institutions. The distrust could in part be ascribed to the knee-jerk attempt of Zia`s regime to Islamise the banking system in the 1980s. Even if the intent was noble, the entire drive ultimately morphed into an exercise of tweaking nomenclatures, such as the labelling of conventional deposits as profitand loss-sharing accounts or riba-based lending as mark-up financing.  
  
That episode engendered a trust gap which is exacerbated by the other deficit of understanding. According to the SBPDFID survey, a whopping 95pc of the banking population admits to having no understanding of the Islamic banking model. The dual banking system, while an otherwise desirable arrangement, has inadvertently blurred the distinction further; Islamic banks are often viewed as a replica of conventional finance. Part of the confusion also stems from the similarity of products that both systems offer.  
  
Islamic bankers rightly argue that simi-larity in final products does not necessarily suggest a similar process under the hood. It is a fair point as there are a slew of other cases where the end results are the same and the only way to determine the legitimacy of a product or process is to examine how it has been executed. For instance, whether or not meat is halal can only be judged by reviewing the slaughter process and not by the final product.  
  
While this argument does provide a reason why legitimacy of a product should not be questioned simply because it looks like a conventional one in its final shape, it nevertheless begs a more fundamental question: are the processes that Islamic banks follow truly very dif ferent? Critics lament they are not. Islamic banks vehemently disagree.  
  
What is still evident is that profitand loss-sharing, a key tenet of Islamic finance, has failed to gain much traction among Islamic banks who rely mostly on debtbased instruments. What lies behind the paltry share of risksharing products in Islamic banking? It might be tempting toblame Islamic banks, but the real culprit it seems is the operating environment.  
  
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Expecting Islamic banks to practise risk-sharing is naïve in an environment of poor rule of law and low trust in public institutions. Withoutdocumenting our economy and strengthening our legal framework, risk-sharing on either deposit or lending is fraught with too many perils to be truly pursued. A country where barely 1pc pay obligatory direct taxes, who would voluntarily share profits with an Islamic bank? In all likelihood, a pure risksharing model will leave the latter at the shorter end of the stick; borrowers will pass on the losses to Islamic banks while pocketing any profits. After all, maintaining two separate accounts is common in our business community.  
  
Without appreciating these realities, the public might be hoping for an Islamic banking model that is too good to exist, at least under the current conditions. Here Islamic banks also have a responsibility to educate the public when the majority admits to having no understanding of their banking model. Without proper knowledge, longheld perceptions will continue to shape public opinion and deepen the twin deficit of trust andunderstanding.m The writer has served as an adviser to the governor, Central Bank of Kuwait.  
  
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