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# Classical Islamic Principles and the Current Model of Islamic Banking in Pakistan

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## Abstract

This paper is aimed to assess the overall perception of the users and stakeholders of Islamic banking towards Islamic banking and finance (IBF). It also intends to find out the crucial points which make the current practices of Islamic banking doubtful for the people and to suggest the appropriate remedial measures to bring about the practices of Islamic banking closer to the teachings of Islam and the *Shari'ah*. Direct survey method was used to assess and evaluate the perception of the users of Islamic banking and finance. However, the study was circumscribed by the opinions of the survey participants, who were limited in number and scattered across a few major cities of Pakistan. The findings revealed that a negative perception about Islamic banking persists due to the various similarities in the procedures, practices, products, and legal framework of Islamic and conventional banks. Moreover, the negative perception is also due to the fact that the same regulator regulates both the banking systems.

**Keywords:** banking laws and regulations, criticism, Islamic banking and finance, perception, regulator

## Introduction

The nucleus of Islamic banking lies in the rejection of *riba* and in the adoption of *Shari'ah* permissible business practices and rules. Therefore, it remains an excellent effort to achieve the objectives of the Islamic economic system and save people from a forced indulgence in interest or *riba*. Islamic banking intends to promote socioeconomic justice and equity by adopting the profit and loss sharing system through partnership, trading of assets (including goods and commodities), and earning of rental income by allowing the usufruct of assets to the customers, instead of directly lending money. As *Shari'ah* allows earning commission through agency agreement,

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the concept of providing *Shari'ah* services under agency contract remains a part and parcel of Islamic banking. Islamic banking is one of the best alternate ideas and initiatives available to deal with the problems created by the impermissible practices of the conventional financial system, especially those centered on *riba*. Hence, it has attracted the general public, practitioners and Islamic scholars right from its inception. However, like every new theory and model, it has also received criticism. The critics of Islamic banking come from every walk of life, including some Islamic scholars. This paper discusses the major points of criticism and concern and suggests possible solutions to satisfy the concerns of the critics.

Among Islamic scholars, the proponents and opponents of Islamic banking and finance (IBF) can be divided into three major groups. The first group includes some of Egypt's Grand Muftis, Imam Khattab of Canada and Javed Ahmed Ghamadi of Pakistan. These are grouped together due to the proximity of their views. This group believes that there is no need of reinventing the banking system in the name of *Shari'ah* compliance when an already developed banking system exists. The Grand Mufti Muhammad Abduh of Egypt "permitted the interest on postal saving", article Dawn News (2009) and Ali Gomaa (2015) said "that modern banking interest is different from usury and that the relationship between individuals and banks is not based on loans, but rather on financing and investment". and Canada's eminent *Shari'ah* scholar Imam Khattab (2014), said "our problem nowadays is our inability to decide whether the interest paid by the bank on money that you deposit in the bank, qualifies as *riba* or not? That is the question on which many people cannot agree. My personal opinion is that it is not *riba*". Javed A. Ghamadi (2015) and his followers are of the view that there is no issue with conventional banking if the banks lend money on profit and in case of loss to the customer, the banks forego profit and recover only the principal amount of the advanced money. The said banking practice can serve the purpose of the *Shari'ah* and the amount paid as profit to the customers of the bank shall not be treated as interest. Ghamadi (2015) also claimed that if the bank or anyone else borrows money to invest in some assets for the purpose of sharing the benefits with the lender, it will not be considered as interest or *riba*.

Mufti Taqi Usmani is the leader of the second group which favors and promotes Islamic banking. This second school of thought proclaims

conventional banking as *haram* (prohibited) due to the sheer involvement of *riba* in its core functions. Mufti Usmani and his followers do not only support Islamic banking but they also directly provide their services to this sector in different fields including advisory, product development, research, *Shari'ah* certification, training of staff, and *Shari'ah* audit and compliance.

The third group does not consider Islamic banking as *halal* (permissible) in addition to conventional banking. This group consists of many eminent Islamic scholars including Dr. Israr Ahmed, Mufti Dr. Abdul Wahid, Mufti Saleemullah Khan, Mufti Hameedullah Jan, Javayd Akbar Ansari, Shykhul-Hadith Zulfiqar Ali, and Mughal Z. S. (2016). This group claims that subterfuges (non-*Shari'ah hiyal*) constitute the basis of Islamic banking. These are equally prohibited and the use of *hila* in Islamic banking makes it worse than conventional banking. Dr. Naik said, "I have never seen any Islamic bank as 100% Islamic." On a question regarding car *ijarah* offered by a famous Pakistani Islamic bank, Dr Israr (2008) said, "It is a *chittasood*" (flagrant interest).

The difference of opinion about Islamic banking among the above three groups of Islamic scholars reveals that the *ummah* has not developed consensus regarding the issue of Islamic banking. The Holy Prophet (PBUH) said, "*My ummah shall never be combined on an error.*" Therefore, it is necessary to review the present practices, products and model of Islamic banking, in terms of the various points of criticism on it.

### **Issues and Criticism on Islamic Banking**

Regarding the *Shari'ah* permissibility of Islamic banking, difference of opinion prevails among academicians, practitioners, researchers and general public, as well as Islamic scholars. We may classify them into two types: "critics" or "opponents" (who criticize, disapprove and disregard Islamic banking) and "proponents" (who favor, approve and consider Islamic banking as *halal* or permissible). Some important points and areas of criticism are given below.

#### **Use of Illegal Subterfuges**

The critics of Islamic banking posit that illegal subterfuges (*hiyal*) constitute the basis of Islamic banking. In 2008, under the headship of Mufti

Saleemullah, almost thirty Ḥanafī muftis (Islamic scholars) issued a *fatwa* wherein they stated, “Since the unreal and temporary grounds of Islamic banking are *murabahah* and *ijarah*, banking with such provisional basis and making these short lived subterfuges (*hilah*) a permanent means of earning, it becomes rather difficult, both morally and as per the *Shari’ah*, to call and consider it as Islamic banking.” Zubair, et al. (2014) claimed, “In fact, Islamic banks are not involved in any kind of trading or sale business, they only deal in money and use illegal subterfuges to fabricate trade transaction.” Usmani (2011) speculated, “Undoubtedly, *Shari’ah* scholars and *Shari’ah* boards have permitted IBIs to perform banking operations which are very closely related and look like stratagems instead of the real banking transactions.” He further said, “IBIs have now begun competing with all of the same characteristics of the interest-based marketplace, and to offer new products that march backwards towards interest-based enterprises. Often times these products are rushed to market using ploys that sound minds reject and bring laughter to enemies.”

Dr. Nimrod Raphaeli in his article, “Islamic Banking – Reality and Myth (2009), quotes Prof Hamid Al-’Ali who contended that, “IBIs disguise usury by inventing documents that appear on the surface as sales documents, but that are actually interest-bearing loans”. Aslam (2012) stated, “IBIs have simply renamed the interest into Islamic terms and they are simply deceiving people into believing that they are complying with the *Shari’ah*.”

Reportedly, the customers approach Islamic banks when they are short of working capital. In fact, they never approach Islamic Financial Institutions (IFIs) for the purpose of trading or buying commodities from them. They only need to bridge liquidity gaps for their businesses and the IFIs create for them a trade transaction which is purely imaginary, where the customers pretend to be buyers, lessee or partners of the banks. In Islamic history, we do not find any evidence of imaginary trade for the circulation of cash (in papers only). What Islamic banks are actually holding for trade? The obvious answer is ‘money’ and it is intended for the businessmen who are short of liquidity but need to circulate their money. On the request of the customers, the IFIs buy the commodities on cash through the customer in general in order to sell them to the same customers

on credit. What happens actually is that the Islamic Banking Institutions (IBIs) use different caps to pretend as traders, lessors and partners to sell the money at profit. Apparently, the following *Ahadith* prohibit such trading transactions:

*“Yahya related from Malik, that he had heard that a man wanted to buy food from a man in advance, the man who wanted to sell the food to him went with him to the market, and he began to show him heaps”, saying, “Which one would you like me to buy for you.” The buyer said to him, “Are you selling me what you do not have?” They approached Abdullah ibn Umar and stated the position to him, to which Abdallah ibn Umar said to the buyer, “Do not buy from him what he does not have.” He said to the seller, “Do not sell what you do not have.” (“Malik’s Muwatta, Book #31, Hadith #31.19.45”)*

*In another Hadith, Yahya related from Malik that he had heard that a man said to another, “buy this camel for me immediately so that I can buy him from you on credit.” It was asked from Abdullah ibn Umar who rejected and prohibited it. (“Malik’s Muwatta Book #31, Hadith #31.33.73”)*

### **Use of KIBOR**

The use of interest rate benchmark (KIBOR) is another objection which the opponents of Islamic banking raise frequently. KIBOR, which is an interest rate benchmark used in the financial market of Pakistan, is also used in Islamic banking for pricing Islamic financial instruments and products. Even the profits of trade and *shirkah* transactions are received on the basis of KIBOR, instead of sharing the actual profits on transactions such as *istisna’a*, *salam* and *musharakah*. These transactions are cleverly structured and the IFIs payback the amount of profit, in excess of the market interest rate, to the counterparty in the name of incentive fee, agency fee or by setting two profit sharing ratios on one transaction. Surprisingly, the transactions in which actual market returns are less than the interest rate, such as the rent of properties, vehicles or other useable assets, Islamic banks do not charge market rents using the principle of ‘*urf*’. Rather, they charge according to the interest rate prevailing in the financial market. In all the said cases, the IFIs continue to follow conventional banking norms. KIBOR

is used by the IFIs in such a way that it comes to resemble the conventional banking interest.

Alshubaily (2018) quoted Mufti Usmani that he eloquently said, “No doubt, the use of the rate of interest for determining a *halal* profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of interest, even this apparent resemblance should be avoided as far as possible”

The Prophet (ﷺ) forbade the delegation of Abdul Qais, to use the utensils for drinks which were used for preparing the alcoholic drinks the Holy Prophet (ﷺ) said:

*“Do not make drinks in Ad-Dubba' nor in Al-Muzaffat. Abu Huraira used to add to them, Al-Hantam and An-Naquir, Al-Hantam and Al-Muzaffat, (Utensils used for preparing alcoholic liquors and drinks)” – SahihBukhari Book 69 Hadith 492b.*

The said pots were used to prepare alcoholic drinks and the Holy Prophet (PBUH) not only forbade the use of alcohol but also forbade the scales, pots and utensils used for drinking alcohol.

### **Mimicry of Interest-based Products**

The use of the replica products of conventional banking is another point of criticism on Islamic banking. Malik, et al. (2011) and Akhter, et al. (2016) raised concerns over the mimicry of the conventional banking products by the IFIs. They said, “Mimicry of the conventional banking products makes IB doubtful to the general public”, and “The IBIs in the name of innovation mimic the same products of CB by renaming with minor changes in documents. It is like presenting alcohol in a different glass and proving it to be a grape juice.” In fact, it is hard to find any single Islamic banking product or mode which is different from those of conventional banking in nature, substance or form. The endorsement of Mufti Usmani, is also available regarding the mimicry of the conventional banking products by the IFIs. He said, “From the face of it, the underlying transaction of Islamic products are *Shari'ah* compliant when taken separately, but when looking at their economic effect one can see that they are not *Shari'ah*

compliant. These so-called Islamic products are *Shari'ah* compliant in their form but not in their spirit" (Usmani, 2011).

### **Islamic Banking Operations under Conventional Banks**

Another common objection on Islamic banking operations is their control and management by conventional banks, particularly the operations conducted under the Islamic Branch Banking (IBB) and window operations. There is a perception among critics that IBB and windows operated and controlled by conventional banks cannot be Islamic. They believe that there should be a clear differentiation and separate operation of *halal* and *haram* financial products under standalone or subsidiary setups, instead of mix operations under one roof, which is similar to the preaching of Islam by non-Muslims. Further support to this argument and perception is also found in the study of KAPS available at the SBP website.

### **Same Laws and Regulator**

Mix regulatory framework is another issue, wherein the Islamic banks operate under the regulatory framework of conventional banks. In window operations, they operate under the management of conventional banks and their boards. Oladimeji et al. (2016), in a study on the IBIs' regulatory framework in Nigeria, found that the operations of Islamic banks under the management and control of conventional banks, the oversight of the same regulator and the same laws for both banking systems were major obstacles in achieving the purpose of Islamic banking and sustaining the spirit of the Islamic financial system. According to Hanif (2011), the governments and the policymakers need to immediately attend to the issue of the same regulations, regulator and regulatory framework for both banking systems. Separate laws for Islamic banking should be the priority of lawmakers for the smooth and consistent growth of the Islamic financial industry.

### **Existing Model of Islamic Banks**

The existing structure of Islamic banks is purely in line with the operational model of conventional banks. Hence, the present legal structure and operational model of Islamic banks are also criticized. Presumably, they are not actually build on Islamic business practices. Hence, they need to be redesigned based on an actual trade or partnership model. Azmat, S. et al.



(2015) proposed a joint venture structure for the management of banking assets and liabilities. Alejandro, et al, (2014) in “IMF working papers on the regulatory system for IBIs”, suggested that “given the risks faced by IBs, there is a need of legal, corporate and regulatory framework as much as conventional banking does.” Zubair et al. (2014) postulated, “Real IFIs are need of the time but they should be based on genuine *Shari’ah* compliant modes like *mudarabah* and *musharakah*.”

*Riba* has been greatly condemned in Islam as it is directly related to the concept of halal (permissible) and Haram (impermissible) in Islam and purification of our income and soul. No doubt, the introduction of Islamic banking is a great initiative taken for the elimination of *riba* from the banking system. Still, the current Islamic banking practices and operations fail to convince people regarding their Islamicity. Indeed, since its inception, Islamic banking has increased the range of its controversial products and practices, which has discolored its image. Recently, the *Shari’ah* Board of a local bank approved commodity *murabahah* as an Islamic financial product in collaboration with the Pakistan Mercantile Exchange (PMEX) for liquidity management of the banking sector. This product proved to be controversial and compromised the *Shari’ah* parameters. Therefore, the *Shari’ah* Board of the SECP stopped its execution and functioning as an Islamic financial product at the PMEX platform.

Based on the above discussed issues and keeping in view other areas of criticism, there is a need to carry out a comprehensive study and review of the current Islamic banking model and products. The low level of confidence regarding the *Shari’ah* compliance of IBIs is also a reason behind the lesser penetration of the Islamic mode of finance in the financial system of most Islamic countries, except a notable few. Even a country like Pakistan, which has over 97% Muslim population, could only achieve the Islamic banking asset penetration of only 17%. Even this was achieved after more than 20-year support of the regulator, educational institutions and a certain class of Islamic scholars. Although the value of global Islamic financial assets has increased to USD 2.7 trillion, as per IFSB’s latest report on financial stability, these assets still comprise less than 1% of the global financial assets. There are 57 Muslim majority countries around the globe,

out of which 40 countries have more than 80% Muslim majority population. However, only 11 Muslim majority countries have IFIs' penetration of 10% or above in their financial markets (IFSB 2018).

### **Literature Review**

The role of customers' needs, perceptions and satisfaction is well-known and well-established in the success of any business. Satisfaction is a feeling which can be evaluated based on the results we achieve against the targets we set. In other words, satisfaction is the evaluation of customers' happiness derived from meeting the expectations and requirements set by any product, service or utility. Islamic banking customers weigh the level of satisfaction in terms of the *Shari'ah* compliance of all products and services offered by the IFIs.

According to Muhammad, et al. (2019), "Islamic bank has received a warm welcome after 2009 financial crisis; the Islamic banks had been selected as an alternative to the conventional banks." Their study revealed that the performance of Islamic banks is better than conventional banks. However, it highlighted certain issues such as *fatwa* shopping, lack of Islamic banking experts, use of conventional products, *Shari'ah* auditing, conventional pricing benchmarks, shaky risk sharing mechanism and the use of conventional banking's regulatory system. Butt, et al. (2018) examined the causes of the low penetration of *Shari'ah* compliant banking and showed that the customers of both banking systems do not perceive Islamic banking as interest-free.

Latif, et al. (2016) studied the customers' perception towards Islamic banking. They showed that customers' perception is vital for the overall growth and future success of the IBIs in Pakistan. They concluded that religious awareness, awareness about Islamic banking products, their underlying structure, bases of services, branch network, and modes of advertising all have a significant influence on the overall perception of customers. Shah, et al. (2016) investigated the perceptions of employees in the IBIs of Pakistan towards the development, growth and practices of Islamic banking. The results disclosed that Islamic bank employees are of the view that IBIs are operating according to the principles of the *Shari'ah*.

Khattak, et al. (2010) investigated the level of customers' awareness and satisfaction towards the IBIs in relationship to demographic variables. They found that a large percentage (67%) of clients maintain their accounts in both banking systems due to their non-satisfaction with Islamic banking services and products.

Zakiah, et al. (2016) did not challenge the *Shari'ah* compliance of Islamic banking, although their research concluded that the customers' ethical behavior affects its growth and a better Islamic ethical behavior can contribute a lot towards the improvement of the IBIs. Bashir (2013) examined the effects of products and service quality on the awareness and level of satisfaction of the customers with Islamic banking in Brunei. According to their research, the customers are aware of the products and services of Islamic banking to a large extent. The findings of this study revealed that the relationship between customer satisfaction and awareness is strong and the promotion of IBIs through creating awareness about them can increase their business. A similar solution was recommended by Thambiah, et al. (2011).

As per Yusuf, et al. (2015), Islamic banking is not completely *riba* free and in line with the principles of the *Shari'ah*. Danjuma, et al. (2015) examined that the knowledge of Islamic banking and its products has a significant positive effect on the perception of customers. Azmat, et al. (2015) strived to develop a theoretical model for a conventional and an Islamic bank in order to show how debt in conventional banks and the *murabahah* instrument in Islamic banks converge under competition. They found that the "Islamic financial instruments differ from their conventional counterparts only in terms of their legal lexicon but have little financial or structural difference."

Zubair, et al. (2014) found that IBIs are not involved in any kind of trade and businesses as they only deal in money with some illegal stratagems or *hiyal*. Malik, et al. (2011) stated that *fatwa* shopping, limited knowledge of the *Shari'ah* scholars regarding banking transactions, existence of different sects and their leaders in Islam, *Shari'ah* auditing, replica products, use of *tawarruq*, issues in *sukuk* and liquidity management create hindrances in Islamic banking.

As per Alomar (2016), Islamic financial intermediation in the world is facing numerous issues, problems and challenges. He stated that there is a need for the re-organization of the whole financial system. Oladimeji, et al. (2016) critically evaluated the regulatory system of Nigeria and identified hindrances which restrict the growth of the IBIs in the country, such as the lack of government support, supporting infrastructure, misconception of the people about Islamic banking, and enabling requirements to make Islamic banking and finance conducive for the customers.

Azmat, et al. (2015) noted that the dominance of asset side debt contracts in Islamic banks is another point of concern. The alternative Islamic Joint Venture (IJV) contracts are considered as the ideal Islamic financing mode. According to Mejia, et al. (2014), there is a need to assess whether the IFIs should be regulated under the conventional regulatory system or a separate regulatory system is required. Hanif (2014) found that IBIs face three very vital challenges towards their existence. These are *Shari'ah* compliance, perception of financial industry practitioners and the perception of a large majority of Muslims. According to the author, two issues at hand demand the immediate attention of policymakers, including a separate law of Islamic banking and the implementation of IFAS.

Hafeez, et al. (2013) posited that Islamic law is not only comprehensive but also provides sufficient elasticity for legislation to meet-out the needs of the modern society. It also covers economic and business affairs, such as *Shirkat al-Amwal* (Company of Capitals), *Shirkat al-A'mal* (Company of Bodies) and *Shirkat al-Wujooh* (Company of Reputations). These companies may be *inan* (limited) and *mufawadah* (unlimited).

Zuryati, et al. (2009) discussed the concept of artificial person and limited liability as debatable, as to whether the principle of a separate legal entity is recognized under the *Shari'ah* law or not. He suggested reconciling the matter through a collective *fatwa* so it may become an *ijma'*.

## Gap Analysis and Discussion

It was found in the literature that in order to rid interest from the financial system, people wish to have true Islamic banking. Customers' confidence on the current practices of Islamic finance is low. Hence, the use and ultimate penetration of Islamic banking in Islamic economies is also

low. Most of the reviewed literature recommends knowledge sharing and awareness programs for the growth of Islamic banking. However, this measure is an arbitrary solution and one needs to think beyond this solution, since merely creating awareness about the current Islamic banking products and practices have changed the mindset of only a few people. The other solutions, as discussed above, are the various independent regulatory frameworks designed for the Islamic financial system. However, what should be the characteristics of this system has not been discussed. The reviewed studies do not recommend what actually is needed, that is, a separate Islamic finance law, an independent and different regulator working with a real *Shari'ah* compliant model based on a *hiyal* free profit and loss sharing mechanism, actual trading of goods and commodities, renting out of assets without the use of interest-based benchmarks and freedom from financial intermediation. These may serve the real purpose of Islamic banking, while addressing the concerns of the majority of the critics of Islamic banking and finance.

The review of the Islamic banking products revealed that there is not even a single product which is an innovation of Islamic banking, exclusively. Hence, Islamic modes and contracts cannot be considered as innovative Islamic banking products. Except the addition of new contracts and some cosmetic changes, all the deposit and financing products and even the end results remain similar to conventional banking. For instance, in *ijarah*, KIBOR rate is charged as rent and asset is ultimately transferred to the customer, similar to conventional banks, by using different tricks. Even the booking period's financial cost is added to the cost of the car, machinery or asset with the aim to ultimately recover it from the customer in the name of rentals. Interestingly, the same asset with a different lease and booking period generates a different amount of rent under *ijarah* arrangement, which is against the normal traditions (*urf*). Moreover, if any customer wants to adjust his *ijarah* or diminishing *musharakah* facility before time, instead of giving him relief (which Islam encourages) at the retirement of obligations, the concerned IBI receives premature adjustment charges from the customer. In DM transactions, the IBIs also charge rent on open plots and under construction houses, on the premise that the *Shari'ah* allows rent on the use of land. Whereas, in the case of DM for home, everyone knows a house is beneficial only after its completion. A critical analysis of the IBIs

gives the impression that all efforts are diverted towards achieving the end results of money market practices and to make interest a legitimate mode for all by using debatable tricks. Sarakeno (2021) in “Islamic Banking - Cheating Allah” said, “The present Islamic banking reminded him the story of people of Sabbath when some Jews living in the village of Ayla, cheated God. The Jews of Bani Israel, were prohibited to work and catch fish on Saturday. But some people of the Ayla figured out a smart way to circumvent the law by setting up their traps a day before the forbidden day, and collect plenteous of fish on the day after Saturday. Allah punished the violators of Sabbath severely and disfigured them into apes.”

The form of Islamic banking practiced in Pakistan does not even have its proper legal definition and defined functions, which could differentiate it from conventional banking. Both banking systems are governed by the same regulator and laws. Every bank gets its operational authority under Banking Companies Ordinance, 1962 (BCO) section 27. The BCO defines banking as:

*“banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise”.*  
[Section 5(b) BCO 1962]

SBP amended the law for Islamic banking by adding clause (aa) of subsection (1) of section 23 of the BCO, which is read as under:

*“A banking company shall not form any subsidiary company except a subsidiary company formed for one or more of the following purposes, namely”:*—

*“(a) the undertaking and executing of trusts”*

*“(aa) the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah;”.*

However, the above amendment neither defines Islamic banking nor explains its functions. The first definition covers financial intermediation and the other is more of an enabling clause intended for establishing

*Shari'ah* compliant subsidiaries of conventional banks, rather than purely Islamic banks.

SBP has defined Islamic banking in the FAQs on Islamic banking, which do not drive legal support from any existing law in Pakistan, since the FAQs are normally considered as clarifications rather than law. Practically, every type of entity having distinct features has been recognized separately in our laws with its specific definition and operations, for example, mutual funds, investment banks, investment advisors, leasing companies, *modarabas* and companies. Nonetheless, Islamic banking does not have any such recognition which needs to be addressed.

The above gaps need to be reviewed and addressed to improve Islamic banking in its real sense.

### **Methodology and Data**

Cross-sectional data was used for analysis in this research paper. The sample consisted of 301 respondents, who were mainly based in three major cities of Pakistan, including Islamabad, Lahore and Gujranwala. The data was collected from the general public, Islamic banking students, Islamic bankers, customers of Islamic and conventional banks and Shariah Scholars who are direct and indirect stakeholders of the Islamic banking (the respondents), using a survey form on the Likert scale format. The opinions of the respondents were sought regarding the points of concern raised by the critics of Islamic banking, as discussed above. The respondents were also asked to share their views regarding the existing model of Islamic banking and if they were not satisfied with it, they could suggest a new model free from the above mentioned points of concern, such as the mimicry of interest-based products, actual trading and partnership, a separate Islamic banking law and regulations, and not using the interest-based benchmark (KIBOR) to satisfy their concerns.

SPSS 21 was used to analyze the data. Principal Component Analysis (PCA) was used to construct the variables, along with the Ordinary Least Square (OLS) method to analyze regression.

### **Reliability of the Research Framework**

The entire scale was found to be highly reliable as the reliability coefficients for all the components were below the cut-off point, that is,

Cronbach's alpha value 0.60, which was set as the standard for this study. Total Number of Items 47 that researcher has used in this research and Cronbach's Alpha based on Standardized items is 0.833.

### Analysis - Respondents' Profiles

In the first section of the survey form, information about the background of the respondents was collected, the details of which are provided in Table 1.

**Table 1**

#### *Profile of the Respondents*

Variable	Group	Nos	(%)	Variable	Group	Nos	(%)
Gender	Male	208	69%	IB Knowledge/ Awareness	N.A.	61	20%
	Female	93	31%		Basic Courses	76	25%
Age Group	< 20 Years	9	3%	Conference, Media etc	71	24%	
	21 – 30	109	36%	IB Graduate	45	15%	
	31 – 40	72	24%	IB Masters	11	4%	
	41 – 50	65	22%	IB MS/PhD	23	8%	
	51 – 60	29	10%	Mufti/ <i>Shari'ah</i> Scholars	14	5%	
	Above 60	17	6%	Profession	Islamic Finance Industry	46	15%
Qualification				Business/Self Employed	52	17%	
	< High School	3	1%	Job/Employee	102	34%	
	Matric/O Level	4	1%	Student/Education	58	19%	
	Inter/A Level	15	5%	Others	43	14%	
	Graduation	65	22%	Income Group	< PKR 20,000	59	20%
	Masters	143	48%	Up to PKR 50,000	52	17%	
	MS/PhD	71	24%	Up to PKR 100,000	96	32%	
			Above PKR 100,000	94	31%		

### Survey Results

The survey results showed that a majority [80%] of respondents had knowledge and awareness about IBF, either through their academics, trainings or awareness sessions. Indeed, 77% of respondents knew that interest is prohibited in Islamic *Shari'ah*, 64% were aware of the use of *riba* in conventional banking, 60% were aware of the *Shari'ah* compliant contracts of accepting deposit in Islamic banking, whereas 59% said that they knew about the basic principles of financing in Islam [Table 2].



**Table 2***Knowledge about Islamic Banking*

	Strongly Disagree	(%)	Dis-agree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
I know <i>Riba</i> (interest) is prohibited ( <i>haram</i> ) in Islam.	33	10.96	14	4.65	22	7.31	34	11.30	198	65.78
I know conventional banking is based on <i>Riba</i> and <i>Haram</i> .	20	6.64	38	12.62	50	16.61	44	14.62	149	49.50
I know about the modes and concept under which IB deposits are accepted.	22	7.31	18	5.98	80	26.58	75	24.92	106	35.22
I know the basis of Islamic financing facilities.	30	9.97	29	9.63	65	21.59	84	27.91	93	30.90

**Table 3***Knowledge about Islamic Banking Products*

	Strongly Disagree	(%)	Dis-agree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
I know about PLS modes – Musharakah & Mudarabah.	28	9.30	22	7.31	46	15.28	95	31.56	110	36.54
I know and understand the concept of Ijarah, Murabahah & DM.	29	9.63	43	14.29	48	15.95	94	31.23	87	28.90
I know and understand the concept of Salam, Istisn'a, & Musawamah.	23	7.64	57	18.94	63	20.93	78	25.91	80	26.58
I know and understand the concept of Wakalah & Gratuitous contracts.	36	11.96	69	22.92	61	20.27	66	21.93	69	22.92

Table 3 shows that 83% of respondents were familiar with the Islamic financing products and modes. The responses showed that 68% knew about *musharakah* and *mudarabah*, 60% knew about *murabahah*, *ijarah* and DM, 52% knew about *musawamah*, and exceptional sales contracts including *salam* and *istisn'a*, whereas 44% were aware about gratuitous contracts and the contract of *wakalah*.

Regarding the questions about their preference of the type of banking to fulfill their needs, 66% of respondents preferred Islamic banking, while only 18% were in favor of conventional banking, and the percentage of indifferent respondents was 17% [Table 4]. Banking preferences were based on the better profit rates (25%), apparent similarities (20%), personal contacts with the bank staff (19%), faith and religious beliefs (58%), and quality of service (41%).

**Table 4**

*Reasons for the Preference of Islamic/Conventional Banking Needs*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
My preference is due to better profit rates.	94	31.23	51	16.94	81	26.91	41	13.62	34	11.30
I prefer conventional banking as I believe there is no difference in Islamic & conventional banking.	103	34.22	74	24.58	62	20.60	36	11.96	26	8.64
My preference is due to personal relations & friendship with bank staff.	120	39.87	55	18.27	67	22.26	38	12.62	21	6.98
My preference for Islamic Banking is due to my faith & religion - if selected	29	10.03	35	12.11	57	19.72	55	19.03	113	39.10
My preference is due to service quality and range of products.	50	16.61	41	13.62	87	28.90	77	25.58	46	15.28

Regarding the resemblance of Islamic banking with conventional banking, a majority of respondents (66%) perceived that it resembled

interest-based banking. The reasons for resemblance were the use of KIBOR (49%), mimicry of the products of conventional banking (38%), conducting operations under the management of conventional banks (45%), and different viewpoints of Islamic scholars regarding IBF (36%). The majority (54%) also believed that the operations of Islamic banks should be in the hands of an independent management, instead of being conducted under the management of conventional banks [Table 5].

**Table 5**

*Reasons for the Negative Perception of Islamic Banking*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
I think use of KIBOR makes it doubtful.	29	9.63	36	11.96	89	29.57	87	28.90	60	19.93
I have doubts on IB as it offers products similar to conventional banks with different names.	45	14.95	65	21.59	75	24.92	70	23.26	46	15.28
Operating under the conventional banks and same management make Islamic Banking doubtful.	41	13.62	41	13.62	86	28.57	89	29.57	44	14.62
Use of fixed rates in financing products like Murabahah, Ijarah and DM makes it doubtful.	32	10.63	61	20.27	97	32.23	76	25.25	35	11.63
Differences among Islamic Scholars (Ulemas) make it doubtful.	40	13.29	48	15.95	103	34.22	62	20.60	48	15.95
I think Islamic Banking should not operate under the same management of conventional banks.	29	9.63	39	12.96	71	23.59	88	29.24	74	24.58

Regarding the perception of Islamic banking as 100% Islamic, the response of 82% of participants was negative. The reasons included the conventional banks' management of Islamic banks (54%), operations under the window setup of conventional banks (42%), Islamic bank branch operations under conventional banks (35%), and not sharing actual profits (44%). Moreover, a large percentage of respondents believed that there is no Islamic banking but its façade is used because banks do not have the option of real Islamic banking [Table 6].

**Table 6**

*Negative IB Perception – Contributing Factors*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
I think IB should not operate under the same management of CB.	29	9.63	39	12.96	71	23.59	88	29.24	74	24.58
CBs are operating windows of IB, these windows cannot be Islamic.	28	9.30	56	18.60	90	29.90	83	27.57	44	14.62
CBs are operating separate IBBs network, these branches cannot be Islamic.	36	11.96	67	22.26	93	30.90	75	24.92	30	9.97
Islamic Banking is not 100% Islamic because it does not work on actual profit and loss sharing modes.	47	15.61	58	19.27	64	21.26	86	28.57	46	15.28
I don't believe Islamic Banking is Islamic. However, I prefer it because no other option is available.	56	18.60	43	14.29	67	22.26	76	25.25	59	19.60

On the questions regarding the operations of Islamic banking, 54% of respondents said that the IFIs should be operated under a separate setup and management, 58% preferred standalone Islamic banks, 61% said that IFIs

should not be a piece and parcel of conventional setups, rather their regulatory system should also be separated from the conventional financial laws [Table 7].

**Table 7**

*Islamic Banks should/should not be a Part of Conventional Banks*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
Operating under the CBs and same management make IB doubtful.	41	13.62	41	13.62	86	28.57	89	29.57	44	14.62
I think IB should not operate under the same management of CB.	29	9.63	39	12.96	71	23.59	88	29.24	74	24.58
CBs are operating windows of IB, these windows cannot be Islamic.	28	9.30	56	18.60	90	29.90	83	27.57	44	14.62
CBs are operating separate IBBs network, these branches cannot be Islamic.	36	11.96	67	22.26	93	30.90	75	24.92	30	9.97
IB should be standalone and not be part of any interest based bank.	23	7.64	49	16.28	56	18.60	113	37.54	60	19.93
IBIs should not be part of interest based financial system. A separate operating system for IBs should be developed.	38	12.62	29	9.63	52	17.28	93	30.90	89	29.57

Table 8 shows that 56% of respondents perceived that under the conventional banking regulator Islamic banks cannot be 100% Islamic, 46% believed that being part of the conventional banking system Islamic banks cannot be truly Islamic, 65% suggested that Islamic banking should have its separate identity and a different look, whereas 58% believed that Islamic banks should have a separate regulator [Table 8].

**Table 8**
*Conventional Banking Regulator should not Regulate Islamic Banks*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
SBP is regulating both IB and CB with the same law. In mix structure it cannot be 100% Islamic.	28	9.30	27	8.97	79	26.25	110	36.54	57	18.94
Separate laws and regulator can make it more Islamic.										
Being part of interest based financial system IBIs cannot be truly Islamic.	24	7.97	43	14.29	95	31.56	93	30.90	46	15.28
Islamic Banking should look different and work as separate entities and not as a part of conventional banks.	21	6.98	31	10.30	54	17.94	105	34.88	90	29.90
SBP regulates both conventional and Islamic banks. Do you think Islamic banks and other Islamic financial institutions should have a separate Islamic finance regulatory authority?	27	8.97	38	12.62	61	20.27	96	31.89	79	26.25

Regarding the operating model, 61% of respondents said that the Islamic banking system should be based on the sharing of actual profit and loss, 56% supported the proposition that IBIs should manage and maintain their warehouses, 66% supported a trading structure based on partnership mode, 58% supported the actual trading of goods and commodities, 55% recommended the working of the IBIs under an IJV set up, and 64% supported the private equity model under *mudarabah* [Table 9].

**Table 9***New Model of Islamic Banking*

	Strongly Disagree	(%)	Disagree	(%)	Neutral	(%)	Agree	(%)	Strongly Agree	(%)
Do you think IBIs should work on actual partnership and PLS sharing basis with the projects undertaken by them?	20	6.64	23	7.64	73	24.25	99	32.89	86	28.57
Do you think real buying/selling of goods, maintaining owned godowns, showrooms or stores can make IB more reliable?	18	5.98	37	12.29	77	25.58	88	29.24	81	26.91
Do you think IB companies and their funding structure (capital/deposit) should be based on real principles of Partnership & PLS system prescribed by the <i>Shari'ah</i> ?	17	5.65	29	9.63	55	18.27	103	34.22	97	32.23
Do you think the IBIs should start actual trading of goods predominantly?	13	4.32	27	8.97	87	28.90	91	30.23	83	27.57
Do you think for actual trade and P&L Sharing IBIs should enter into Partnerships ventures with the traders & manufacturers by equity sharing like funds, venture capital and private equity.	12	3.99	31	10.30	92	30.56	106	35.22	60	19.93

	Strongly Disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly Agree (%)					
Do you think a true IB model should be based on Mudarabah structure and it should not deal in all doubtful transactions resembling CB and dealing in fixed return financing facilities?	18	5.98	20	6.64	71	23.59	89	29.57	103	34.22

## Regression Results and Analysis

The variables were used to calculate the impact on the perception of people regarding Islamic banking. The results depicted that the selected variables created a negative impact on the perception of the respondents, except the variables “awareness” and “new model of Islamic banking”. The rest of the variables had a considerable impact and significantly enhanced the negative image and perception of IBF. Awareness did not have a negative impact but its contribution was insignificant [Table 10].

**Table 10**

### *Coefficient Calculations*

Variables	Coefficient	Std. Error	T Value	P- Value
Constant – Perception	6.775	1.290	5.237	0.000
Awareness/Knowledge (A)	0.79	0.042	1.888	0.060
KIBOR (K)	1.482	0.144	10.312	0.000
Replica Products (S)	1.515	0.264	5.734	0.000
Operation under Conventional Banks (O)	1.443	0.118	12.242	0.000
Regulatory framework/Regulator (R)	1.119	0.169	6.626	0.000
New Model (N)	0.156	0.077	2.034	0.043

It was found that the respondents either had an education in Islamic banking or they were aware of the concepts and basis of IBF. Still, they believed (including *Shari'ah* scholars working in Islamic banking) that it is



not 100% Islamic. There are many reasons for considering Islamic banking as partially Islamic, which include the resemblance of Islamic banking products and operations with those of conventional banking, use of conventional banking's interest charging benchmark (KIBOR), and control by the conventional banking regulator and laws. An Islamic banking model free from the said issues was deemed appropriate for *Shari'ah* compliant banking by the majority of the people who participated in the survey.

## Conclusion

It is believed that public perception is one of the key causes of future growth or decline of any business, product or industry. Islamic banking is a largely growing sector; still, it has not gained its due place and share in the financial market, even in Islamic countries. Therefore, this study was conducted with the major objective of assessing customers' perception towards Islamic banking, finding the causes of its negative perception (if any), and improving this perception for the future growth of IBF. It was found that the majority of the people wish to practice and opt for Islamic banking but they have reservations about its present form. Indeed, their negative perception has restricted their growth and market share. The study showed that in spite of many on ground efforts of the proponents of Islamic banking, including education, researches, media campaigns, awareness and training programs conducted during the last two decades, the customers of Islamic banking are not fully satisfied with its Islamicity and *Shari'ah* compliance. The variables used in this study, which also constitute major points of criticism and concern, showed a negative impact on Islamic banking of customer perception.

The conventional banking system satisfies economic needs but it does not fulfill religious needs. Therefore, a banking system is required which could satisfy both the religious and economic needs. Islamic banking, for economic needs, may be as good as the conventional banking system. However, it does not fully satisfy the religious needs due to its controversial and debatable banking products and practices. A real Islamic banking model needs to be based on real partnership concepts, economic activities, and trade and rejection of interest in a true sense and without any camouflage. Financing activities or the asset book of the Islamic banks is a major point of concern and suspicion. IBIs should not operate in a way that the existing

interest producing factories are operating and their regulator and laws should also be separate and independent.

Real Islamic banks can solve many of the issues regarding the mode of operation of IBIs but they need a separate regulator and laws, changes in their existing corporate structure, and adopting the *mudarabah* based legal entity model as provided in the *Modaraba Companies and Modaraba Ordinance, 1980*. The IFIs should be involved in actual trade instead of trade in papers, manufacturing or renting businesses, either through complete ownership or partnership. They should share actual profit rather than restricting it to the KIBOR rates. The financial models of IFIs, such as Allied Rental, Imrooz trading and Treet Manufacturing *modarabas*, are referred to for further studies.

The newly proposed model for the IBIs may include the establishment of divisions for each business segment and the hiring of related experts in trade, rental businesses, manufacturing, asset-based financing and investment activities. The IBIs should own and maintain their own stocks of commodities, warehouses and outlets in each city of their major operations, as the showrooms and outlets of large chains are doing. They need to provide additional counters and facilities for normal banking transactions aimed at cash collection, payment, remittance, import, export and other services.

The remodeling of the current Islamic banking system on the basis of true Islamic principles of trade, partnership, investment, rent and agency can bring the Islamic financial system closer to the *Shari'ah*. Economic activities based on a true Islamic financial system may ensure sustainable economic growth, increase in GDP, employment and fair distribution of wealth. Moreover, it is also the responsibility of the state to provide a real Islamic financial system to its faith-based citizens, instead of a suspicious and dubious Islamic banking model.

## **Recommendations**

1. Islamic banking and finance laws should be formulated to undertake Islamic banking and Islamic capital market activities under a regulator different from the regulator of conventional banking and finance.

2. The legal and corporate structure of IFIs should be based on partnership or investment model, addressing the *Shari'ah* issues of limited liability and explicating an exit mechanism for the partners.
3. The investment of IFIs should be at least 51% in actual tradable assets, business partnerships holding the ownership and possession of inventories under IFIs, joint ventures, or partner maintained and managed showrooms, godowns and stores, instead of doing mere financial intermediation.
4. According to their major line of trading, rental or manufacturing business, the IFIs should hire industry experts for partaking direct risk and management in actual businesses.
5. The pricing (profit and rent) mechanism of the IFIs should be linked to the market practices of related commodities and assets, instead of money market benchmarks.

The above actions delimiting a new model of Islamic banking can ensure the provision of true *Shari'ah* compliant financial and business services to faith-based customers, rather than an eye wash in the name of Islamic banking. The concept of Islamic banking will flourish more rapidly if its form and substance is also Islamic, convincing and trustworthy for the people.

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