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Author(s): Sahibzada Muhammad Wasim Jan¹, Hassan Shakeel Shah²
Ahmad Azam Bin Othman¹

Affiliation: ¹Ahmad Ibrahim Kulliyah of Laws, International Islamic University, Malaysia
²Sultan Omar Ali Saifuddien Center for Islamic Studies, University of Brunei Darussalam, Brunei

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An Analytical Review of the Influence of Regulatory and Supervisory Bodies on the Business of the Islamic Financial Institutions (IFIs) in Pakistan

Sahibzada Muhammad Wasim Jan¹, Hassan Shakeel Shah^{2*} and Ahmad Azam Bin Othman¹

¹Ahmad Ibrahim Kulliyah of Laws,
International Islamic University, Malaysia

²Sultan Omar Ali Saifuddien Center for Islamic Studies,
University of Brunei Darussalam, Brunei

Abstract

Islamic financial market in Pakistan comprises Islamic banking, *Takaful* and Islamic capital market. It is regulated and supervised by the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP). Despite the regulatory and supervisory mechanism crafted by these authorities, there are other institutions such as the Council of Islamic Ideology (CII), Federal *Shariat* Court (FSC) and international institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) which intervene and influence the Islamic banking practices. Based on an analytical approach, the current study found an overlapping situation in the authority exercised by these bodies over the business of the IFIs in Pakistan. Hence, a distinctive regulatory authority based on an adequate legal foundation should be created to watch over the business of the IFIs in Pakistan. The supreme authority can be conferred to the *Shariah* Advisory Committee (SAC) of the SBP or to a separate body in the current judicial infrastructure of the country in order to overview, harmonize and resolve the issues related to the business of the IFIs.

Keywords: Council of Islamic Ideology (CII), Federal *Shariat* Court (FSC), Islamic Financial Institutions (IFIs), regulations, State Bank of Pakistan (SBP), Securities and Exchange Commission of Pakistan (SECP)

Introduction

The world is witnessing the tremendous growth of Islamic banking. The number of IFIs is growing rapidly around the globe. According to a report published by Ernst and Young (2014-15), the assets of Islamic banking were expected to exceed USD 778 billion by 2014, while the global profit pool for the Islamic banking industry was expected to triple by 2019. It also highlighted the assets of the Islamic banking

*Corresponding Author: hassan.shakeel@umt.edu.pk

markets in Qatar, Indonesia, Saudi Arabia, the United Arab Emirates, Turkey and Malaysia which can reach the figure of USD 1.8 trillion by 2019. Moreover, the assets of global Islamic banking also acquired a compoundable annual growth rate (CAGR) of almost 17% from 2009 to 2013. The market share of the Islamic banking industry was estimated as 48.9% in Saudi Arabia, 44.6% in Kuwait, and 27.7% in Bahrain. Likewise, an impressive performance was observed in Indonesia where its market share touched 43.55%, whereas in Turkey it grabbed 18.7% of the market share and in Pakistan, it secured 22.0% CAGR between 2009 and 2013 (Ernst, [2015](#)). The current competitive financial market indicates that the Islamic financial market has the potential to become a trillion dollar industry not only at the domestic level but also at the global level (Ghazal & Zulkhibri, [2015](#)).

The balanced and robust financial facilities of the Islamic banking system are attracting considerable attention from within and outside the Muslim world. The scale and verities of financial activities, transactions, contracts, modes of financing, financial and banking instruments and products, and systematic procedures indicate the complexity and vastness of the Islamic banking industry. The enormity of all these activities and procedures warrants two types of systematic arrangements, that is, regulatory and supervisory. The stability of the financial system does not rely only on a single institution; rather, it depends on an interlinked set up among these institutions or sectors. This is why different types of financial institutions, diversified financial services and a variety of transactions need to be regulated and supervised by the relevant authorities (Chapra & Khan, [2000](#)).

Islamic financial system requires discipline in financial affairs through adequate regulatory and supervisory mechanisms in order to maintain stability and certainty in the market (Chapra & Khan, [2000](#)). Therefore, the main objective of regulations is to establish positive norms in the financial market and secure the banking system from failure. Without appropriate regulations, the market cannot achieve certainty, stability and social prosperity (Khalid et al. [2011](#)). Hence, the responsible authorities of the countries where the Islamic banking system is operational have the duty to formulate rules and regulations according to their respective laws in order to regulate the business operations of the IFIs. In this regard, the State Bank of Pakistan (SBP), Bank Negara Malaysia (BNM) and authorities in some other countries have issued guidelines, directives and circulars to regulate the business of the IFIs in their respective countries (Dusuki, [2011](#)). A sound regulatory and supervisory arrangement is a substantial need for the sustainability of the Islamic financial system. More importantly, regulatory and supervisory measures might not be effective without an adequate legal foundation because it may cause serious issues such as governance, managerial and financial

disruptions previously witnessed in some countries (Ghobakhloo et al. [2012](#)). It also creates some managerial and reputational risk which maximizes the uncertainty in the industry.

In Pakistan, the Islamic finance industry has faced many hurdles and challenges throughout its history. These challenges instigated the authorities to emphasize the establishment of an effective regulatory and supervisory infrastructure in order to monitor the business of the Islamic finance industry. SBP has the statutory mandate to regulate and supervise the business of the IFIs in the country. Moreover, there are other institutions which also influence the regulatory and supervisory process specified for the Islamic finance industry in Pakistan. The current study intends to examine the role and influence of five institutions on the business of the IFIs in Pakistan. These are (i) the State Bank of Pakistan (ii) the Federal *Shariat* Court (iii) the Council of Islamic Ideology (iv) Securities and Exchange Commission of Pakistan and (v) two international standards setting institutions namely Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB). It attempts to analyse the extent of influence of each institution in regulating and supervising the business of the IFIs in Pakistan. The objective of the current study is to investigate whether the Islamic finance industry in Pakistan has a uniform regulatory mechanism or a unified authority is needed to synchronize these activities in one institution.

2. State Bank of Pakistan (SBP)

SBP plays a key role in supervising and regulating the Islamic banking system in the country. It is the only institution which acts as a central regulatory authority for the banking sector in Pakistan. It was established in 1949 and at its inception, it was injected with the spirit of the Islamic economic system. The speech of the founder of the country Muhammad Ali Jinnah delivered at the inauguration ceremony of the SBP set its strategic direction towards an Islamic economic system (PIBSR, [2003-2007](#)). The main role of SBP is to control the monetary and other banking and financial rules and regulations and to supervise the implementation of these regulations in the country's banking and financial sector in general. Similar to the role of other central banks, it is also entrusted with primary and secondary functions. Primarily, the SBP is responsible to produce bank notes, regulate the financial market, act as the lender of the last resort and organize the monetary policy. Secondly, it has to manage the foreign exchange policy, assist the government to introduce financial policies, supervise the payment system and establish conduit economic relations with domestic and global institutions (Arby, [2004](#)).

SBP Act, (1956) is the key legal document which spells out the authority of the SBP over the banking and financial affairs of the country and it has been augmented through various amendments. These amendments have reinforced the managerial powers of the central board of the SBP in order to stabilize the monetary policy, augment the financial market and to introduce credit policy in response to the objectives of the government towards financial growth, reducing inflation and managing the foreign assets of the banks through robust monetary and credit policies (SBP Act, 1956). The act grants SBP the authority to maintain balance in liquidity and credits for the federal and provincial governments and their associated institutions. It is also given the authority to set the credit requirements for private entities through collaboration with the Monetary and Fiscal Policies Co-ordination Board (MFPCB) (SBP Act, 1956). It has been obliged to keep the parliament abreast with its progress by submitting quarterly reports. On the other hand, the act also bars the government and its affiliated institutions to roll out any directives to control the affairs of banking or financial institutions which fall under the regulatory purview of the SBP and are governed by the SBP Act 1956 or the Banking Companies Ordinance (BCO) 1962 or any other prevailing law (SBP Act, 1956). BCO 1962 is also another legal source which supports the banking business in Pakistan but its provisions encompass the banking activities in general without any particular consideration to the business of the IFIs SBP, 2014-2018. It generally states the conformity of the business carried out by the IFIs. Since the 1980s and 1990s, SBP has performed its role effectively in introducing and facilitating the implementation of rules and regulations for the Islamic finance industry. In this regard, SBP has issued several guidelines and parameters for banking and financial products and services. Unluckily, these efforts have not lasted due to legal and regulatory challenges including the patronage of Shariah non-compliant transactions in some banks (Saeed, 2011).

These reasons have stagnated the efforts of developing the Islamic banking sector in the country for some years. However, the past experiences of shifting policies for the economy provide sufficient background for the next phase of the evolution of Islamic banking in the country. In the light of these experiences, the authorities decided to pursue a dual system, that is, a conventional system parallel to the Islamic financial system, also known as the Malaysian model. This phase which started with the decision made by the Federal *Shariat* Court (FSC) that declared the practice of Islamic banking “un-Islamic” in 1991 ended when the *Shariat* Appellate Bench (SAB) of the Supreme Court directed the government to bring a number of banking laws into conformity with Islamic injunctions by June

30, 2001 (Lobo & Bonello, [2005](#)). In this regard, the government took the decision to reestablish the industry with new strategies and approaches.

SBP also took several measures and initiatives to promote the Islamic finance industry in the country following the directives and guidelines given by the SAB of the Supreme Court of Pakistan. Firstly, a commission for the transformation of the financial system was established to prepare the strategies and policies needed for the promotion of an Islamic financial system. Secondly, to pursue the proposed reforms, the SBP articulated an exclusive department of Islamic banking in its institutional architecture in 2003 in order to implement and supervise strategies and regulatory plans (IBSR, [2007](#)). The Islamic Banking Department (IBD) of the SBP is entrusted with the role to introduce policies, directives, guidelines and to supervise the behavior of the IFIs towards the implemented policies and guidelines. It also overviews important aspects such as issuing licenses for the IBIs, supervising and regulating *Shariah* auditing and enhancing the professional capabilities of the Islamic banking officials through convening a variety of training sessions, talks, seminars and conferences (Akhter, [2006](#)). IBD, with the collaboration of international Islamic regulatory bodies such as AAOIFI and IFSB, arranges in-house training courses and workshops and takes part in such activities internationally by sending its officials to adopt and promote the international harmonizing and regulatory practices for Islamic banking and finance (SBP Act, [2018](#)).

Moreover, SBP has enhanced the performance of the industry by formulating a two-tier *Shariah* compliance framework which consists of a *Shariah* Advisory Committee*¹ (SBP, 1999) (SAC) at the State Bank level entrusted with the responsibility of approving the Islamic banking policies and guidelines, vetting of the appointment of the *Shariah* Advisors in Islamic banks according to the Fit and Proper Criteria issued by the SBP, approving the requirements for the appointment of a *Shariah* Advisor in all Islamic banks to supervise and provide *Shariah* compliant guidance to the banks as well as an effective *Shariah* audit system through a *Shariah* compliant inspection mechanism (Akhter, [2007](#)). Besides, there is also a future plan envisaged by the SBP to strengthen the legal framework. One should keep in mind that the current legal infrastructure titled Banking Companies

*The Judgment of *Shariah* Appellate Bench of the Supreme Court of Pakistan revealed in 1999 provided the legal base for the establishment of SAC at the central bank of Pakistan. The Supreme Court directed the SBP to articulate the *Shariah* Board into its organization in order to provide guidance and regulatory assistance to the SBP over Islamic banking operations. See: Judgment of *Shariah* Appellate Bench of Supreme Court of Pakistan, (1999), Para 7(a) at page 1013 of judgment dated the 23rd December 1999, in civil *Shariat* Appeals No. 1 of 1992 etc.

Ordinance 1962 governs both the conventional and Islamic banking sectors. It does not provide any distinctive legal provisions about the business of the IBIs. Therefore, the stakeholders visualized to create an exclusive legal arrangement to support the regulations for the Islamic banking industry. In this regard, the state is considering to make adequate legal amendments in the BCO 1962 as well as in the SBP Act 1956. The legal modifications are also expected to include the Recovery of Finance Ordinance 2001 and the Microfinance Institutions Ordinance 2001 in order to establish an effective and robust regulatory framework for the better performance of the Islamic banking industry in the future (SBP, [2014](#)).

SBP has a major influence on the business of the IFIs because it has been conferred with regulatory authority by the current legal infrastructure to regulate and supervise the country's banking industry through its different organs. Its regulatory purview also includes the business of the IFIs. The regulations and standards issued by the SBP are governed by the same legal arrangement, that is, BCO 1962. In this regard, the responsibility is shared between the IBD and the SAC of the SBP to control, supervise and advise the regulatory practice regarding the business of the IBIs at macro level, whereas the institutional *Shariah* board acts to complements the supervisory role of the SAC at institutional level. In spite of the fact that SBP has been conferred with the legal authority to regulate the business of the IBIs, yet this authority is not solely decisive in the sense that there are other bodies which also influence the business of the IBIs, directly or indirectly. The other bodies which may or may not intervene and influence the business of the IFIs include the Federal *Shariat* Court of Pakistan (FSC), Council of Islamic Ideology (CII), Securities and Exchange Commission of Pakistan (SECP) and some cross-border standards setting organizations. Although, their particular roles are not regulatory because that is the prerogative of the SBP, yet they influence the business of the IFIs. Some influence the operational behavior of the IFIs while others have legal influence. Some even intervene in the regulatory arrangement as well. The details of all such bodies and their level of influence are discussed below.

The overlapping situation where different bodies can influence the business of the IFIs may cause impediments in the successful outreach of the Islamic financial services in Pakistan. Therefore, it is imperative for the stability and smooth growth of the business of the IFIs that it is supervised through a consolidated authority. In this regard, the role of SAC that operates under the aegis of the SBP can be augmented through regulatory and legal support. The composition and jurisdiction of SAC also require some reforms in terms of its size which should be extended and more qualified experts with different expertise should be included in it. More importantly, the *Shariah* scholars must be selected based on their diverse

experiences and international exposure to Islamic banking and financial operations and practices. Likewise, the jurisdiction of the SAC should encompass all kinds of businesses which involve Islamic banking and finance. The inclusion of members with diverse qualifications in addition to their international exposure would enhance the capability of the SAC to oversee all business affairs of the Islamic finance industry in Pakistan. It will eventually harmonize and organize the regulatory and supervisory process for the industry which would also strengthen and boost the business of the IFIs to meet the level expected of them.

3. Federal *Shariat* Court

The initial establishment of the *Shariat* Court was in the form of *Shariat* benches created in the four high courts of the four provinces and a *Shariat* Appellate Bench created in the Supreme Court of Pakistan with the constitutional amendment order 1979 issued by the president. Afterwards, with another constitutional amendment (presidential order), all four *Shariat* benches of the high courts were merged to create the Federal *Shariat* Court on 26th May 1986. The eighth amendment of the 1973 constitution approved by the parliament in 1985 signaled a green light for the inception of the first Federal *Shariat* Court (FSC) in Pakistan. According to the Article 203C of the Constitution of Pakistan, the Federal *Shariat* Court shall consist of not more than eight Muslim judges including the Chief Justice to be appointed by the president. The Chief Justice shall be a person who is or has been or is qualified to be a judge of the Supreme Court or who is or has been a permanent judge of a High Court. Of the judges, not more than four shall be persons each of whom is or has been or is qualified to be a judge of a High Court and not more than three shall be Islamic scholars possessing at least fifteen years of experience in Islamic law, research and instruction. The Chief Justice and a judge shall hold office for a period not exceeding three years but may be appointed for a further term or terms as the president may determine.

Article 203D of the Constitution of Pakistan sets the powers, jurisdiction and functions of the court. It states that the court may, either on its own motion or on the petition of a citizen of Pakistan or the federal government or a provincial government, examine and decide the question whether or not any law or provision of law is repugnant to the injunctions of Islam as laid down in the Holy Qur'an and *Sunnah* of the Holy Prophet (PBUH), here after referred to as the injunctions of Islam. When the court takes up the examination of any law or provision of law and such law or provision of law appears to be repugnant to the injunctions of Islam, the court shall notify it to the federal government if the matter falls under the federal legislation list. It shall be communicated to the provincial government when the

case comes under its authority. The government is given the opportunity to express its point of view on such laws placed before the court. In case the court decides that such laws or provisions violate Islamic injunctions, it will have to justify the grounds for its decision along with an explanation on to what extent such law contradicts Islamic injunctions and also record other particulars of the decision.

The Article 203D, Clause (3) also explains that if the court sees any law or provision of law as contradictory to Islamic injunctions, such laws or provisions shall be amended and transformed into the standard of Islamic injunctions with presidential support. Moreover, the effect of such laws and provisions shall be revoked immediately after the court's decision. However, the affected parties are given the right to appeal against the FSC's decision at the Supreme Court (COP, [1973](#)).

The above functions and legal powers are stipulated in the constitution. Thus, any law or legislation which violates Islamic injunctions including the practice of Islamic banking and finance would fall under the jurisdiction of the Federal *Shariat* Court. However, fiscal and financial laws were excluded from its jurisdiction immediately after its inception. This exclusion was initially defined for three years. Later on, it was extended up to ten years. The reason behind this exemption was that the elimination of interest from the economy could not be made immediately due to various challenges. It was decided that interest bearing transactions in the economy could be extracted only in a gradual manner when the country's financial system is ready for it (Ul-Hassan, [2007](#)). Lobo and Bonello ([2005](#)) also indicated that the monetary and fiscal issues of the country's financial system had been kept out of the judicial power of FSC up to June 26, 1990. It was on November 14, 1991 when the jurisdiction of FSC was absolutely restored, it started discharging its judicial functions towards fiscal and monetary laws as well. After hearing 115 petitions challenging 20 banking and fiscal laws, it found that the provisions for interest in these laws came under the definition of *riba* and were, therefore, inconsistent with the injunctions of Islam. It set a deadline of June 30, 1992 after which the various provisions would cease to have effect (Lobo & Bonello, [2005](#)).

FSC declared in one of its decisions that the practice of Islamic banking in Pakistan is un-Islamic because it is being practiced under the unclear mark-up based system. The decision shook the industry which instigated the government and the banks to appeal before the *Shariat* Appellate Bench (SAB) of the Supreme Court of Pakistan (SCP). SAB rejected the appeal and upheld the FSC's decision. Moreover, SAB also directed the government to reintroduce the Islamic banking system based on the guidelines specified in the court's judgment. It also added in

its judgment that the government should establish a commission for the transformation of the banking system in SBP and two other task forces in the ministries of law and finance to enhance the reintroduction of an Islamic banking industry. An appeal to revise SAB's decision was filed by the United Bank Ltd and other parties which made the SAB of the SCP to send the case back to FSC to have a fresh hearing (Chohan & Chohan , [2012](#)).

Federal *Shariat* Court has quite a long history of significant involvement in the Islamic banks' regulatory and supervisory process which reflects its considerable influence on the business of the IFIs. Hasan labels the regulatory framework of Pakistan as an "interventionist approach", which means that there is an institution holding the highest authority besides the SAC of the SBP to resolve Islamic finance issues and that institution is the Federal *Shariat* Court (Hasan, [2012](#)). Moreover, the influence of FSC has been identified also by Dusuki. He states that "Pakistan also has a distinctive position whereby the Federal *Shariat* Court is the ultimate arbiter on *Shariah* matters and has twice (in 1991 and 1999) made a ruling requiring the whole banking system in Pakistan to be made *Shariah* compliant" (Dusuki, [2011](#)). Meanwhile, Chapra and Khan ([2000](#)) also state that "the Federal *Shariat* Court (Pakistan) is empowered to review all laws in the light of the *Shariah*. It has declared interest to be a form of *ribā* and the existing system of mark-up transactions to be interest based and hence unlawful" (Chapra, [2000](#)).

A similar situation is witnessed also in the Malaysian legal arena where the Islamic finance industry was at risk due to some legal challenges faced by the *Shariah* Advisory Council (SAC) of the Bank Negara Malaysia (BNM). The point of dispute were Section 56 and 57 of the Laws of Malaysia ([2009](#)) which provide the ultimate authority to the SAC of BNM on *Shariah* matters involved in Islamic finance. According to the said sections, the courts and arbitrators in Malaysia are advised to decide Islamic finance cases in the light of the published rulings of the SAC of BNM or to request for its resolution in case the published rulings are silent on such issues. Moreover, the rulings of the SAC of BNM have been granted binding force (Laws of Malaysia, [2009](#)).

It is worthy to note that Section 56 and Section 57 of the Central Bank of Malaysia Act 2009, which grant binding force to the rulings of the SAC of BNM, were questioned and their applicability was challenged in a renowned legal case named Tan Sri Abdul Khalid Ibrahim v Bank Islam (M) Bhd (Ibrahim, [2013](#)). Bank Islam Malaysia Berhad, which was the respondent in the case, pleaded the court to refer the case to SAC in order to seek its ruling in compliance to Section 56 but the plaintiff in this case objected to that referral. The plaintiff argued that the Sections

56 and 57 contradict the Article 8 and 74 as well as Part IX of the federal constitution of Malaysia; therefore, referring the case to the SAC for its ruling would usurp the authority of the judge. After a thorough litigation process, the court declared that the two sections do not contradict the federal constitution because they are parts of the act formulated by the parliament of Malaysia while exercising its constitutional function. It was also declared by the court that seeking advice or ruling of the SAC in compliance to the said sections would not usurp the judicial authority because the ruling of the SAC only facilitates the court by ascertaining the required Islamic law with the respective matter and the court has to decide the applicability of such ruling to the case.

Another legal matter was brought before the Federal Court of Malaysia in a case titled *JRI Resources Sdn Bhd v Kuwait Finance House (M) Bhd (President of Association of Islamic Banking Institutions Malaysia & anor, intervener, 2019)*. The court had to decide the validity of the same two sections. It was again objected that seeking the rulings of the SAC in accordance with the Sections 56 and 57 would contravene Part IX and Article 121 of the federal constitution of Malaysia which spells out the judicial functions. However, the court decided the matter otherwise. In a majority decision, the court declared that the ruling of SAC under the said sections does not obstruct the judicial power to decide the legal disputes, neither the SAC has the responsibility to settle the dispute. It is the prerogative of the presiding judge to decide and settle the issue. Therefore, seeking the ruling of the SAC by referring the case does not usurp the judicial function nor it is unconstitutional. The court also explained that SAC is a consolidated body of expert individuals from the field of the *Shariah*, economics, finance, law and banking and its primary role is to harmonize *Shariah* interpretations, devise its expert opinion and ascertain certain Islamic laws on Islamic financial affairs.

On the other hand, the jurisdiction of FSC is not limited to the issues related to Islamic finance and banking. Rather, it has a wider scope of jurisdiction encompassing all *Shariah* matters including the business of the IFIs. It is because of the fact that FSC is required by the constitution to examine the legislation in the country and to bring it into conformity with Islamic law. This is the cause of an uneven and unstable situation in Pakistan's Islamic finance system. If the government establishes a sole authority to exclusively investigate matters regarding Islamic finance such as the *Shariah* Advisory Council of Malaysia, the regulatory infrastructure would function more effectively and become more stable. A legal support would provide a sound foundation to the proposed authority and its resolutions and rulings would have decisive effects on the business of the IFIs.

4. Council of Islamic Ideology

The Council of Islamic Ideology (CII) has a long history of active participation in the efforts for the Islamization process in Pakistan, particularly in Pakistan's socioeconomic life. It was established under the Article 199 of the 1962 constitution of Pakistan on 1st August 1962. Initially, it was known as the Advisory Council of Islamic Ideology. Later on, it was re-designated as the Council of Islamic Ideology (CII) under Article 228 of the 1973 constitution. The constitution also specified its composition under the same article, whereas the terms of reference to it are stated under Article 229. Article 230 spells out the functions of CII, whereas the rules of procedure are defined by Article 231. Since 1962, CII has been playing its role effectively by submitting various reports to the parliament recommending possible modifications in several laws. Moreover, it deliberates the references sent by the president, governors, the national assembly and the senate and also conducts research, seminars, and conferences. Its key functions defined by the constitution are as follows:

- To make recommendations to the country's legislative assemblies (the parliament and the provincial assemblies) regarding how the people of Pakistan can live in harmony with the teachings of Islam.
- To guide the parliament, the provincial assemblies, the president, and the governors on any issue sent to the council for advice. This is with regard to whether any proposed legislation violates Islamic injunctions or not.
- To propose the measures for implementing the existing laws of the country in compliance with Islamic injunctions and to provide guidance for the implication of these measures.
- To produce a list of the proposed Islamic injunctions and to present it before the national and provincial legislative institutions in order to make sure that the recommendations are considered accordingly. However, any law which requires its immediate formulation in public interest could be pursued without prior approval from the CII. The legislation described by the CII as contradictory to Islamic injunctions must be considered by the legislators.

The functions of CII are general in the sense that they are not limited to supervise the business of the IFIs; rather, they encompass all legal matters related to Islamic injunctions in the country. Therefore, CII makes the considerable contribution of bringing many laws and legal matters in conformity with Islamic law. Particularly, in the area of Islamic banking, CII has the main role in laying the theoretical foundation for establishing the Islamic financial system in Pakistan.

The major contribution of CII in the area of regulation and supervision was witnessed during the 1960s and 1970s when it recommended several measures and guidelines for an interest-free financial system in Pakistan. It also conducted a comprehensive field research between 1966 and 1976. The research was aimed to generate opinions, suggestions, instructions and recommendations from experts such as bankers, scholars, economists and local and foreign academicians on how interest could be eliminated from the country's financial system. It prepared a final report and presented it to the then government. Unfortunately, the government did not pay appropriate attention to that report. However, the government of Zia ul Haq showed an unprecedented interest in Islamizing the country's economy. In this regard, CII was given a special task to construct the basic infrastructure for the Islamization of the banking sector. Hence, it prepared a report with the assistance of a panel of well-known economists, bankers and other experts, recommending the basic legal and operational framework for an interest-free banking system which was submitted to the government (Ul-Hassan, [2007](#)).

The recommendations and advice of CII are not binding because its role is merely advisory. For that reason, it has less executive influence upon the country's legislative process and even on the business of the IFIs. It has been observed that CII comprises members from different sects which provides a solid and balanced base for the measures proposed by it for legal and other matters in the country. Islamic finance also falls under its jurisdiction. It has also been observed that the range of its jurisdiction includes Islamic finance but without any specification. Thus, CII still has to prove that it is in the position to provide robust and effective solutions to the regulatory and supervisory issues affecting the business of the IBIs in Pakistan by recommending or suggesting effective reforms. However, a feasible solution to this issue can be the presence of an exclusive and specialized body in the area of Islamic finance which may fulfill the regulatory and supervisory needs of the IFIs. A body with qualified members may deliberate the issues of Islamic banking and finance more professionally. It will not only contribute to the industry by harmonizing and standardizing the business practices of the IFIs but will also enhance the quality and efficiency of the IFIs in the country.

5. Securities and Exchange Commission of Pakistan (SECP)

The Security and Exchange Commission of Pakistan (SECP) came into existence under the SECP Act, 1997. The said act aims to provide a legal basis for the basic infrastructure, regulatory authority and supervisory role and responsibilities of SECP. It began to function in 1999 by regulating and supervising the corporate sector and covering the capital market, insurance companies and non-banking

finance companies. In recent years, the mandate of SECP has been extended to cover investments, financial services, leasing, housing finance services, venture capital investment, discounting services, investment advisory services, real estate investment trust, asset management services and other financial activities. Moreover, SECP supervises and regulates the functions of other institutional and individual firms which provide external financial services. The organizational structure of SECP consists of different organs. It comprises four members including a chairman who acts as the chief executive officer of the commissioners. The four members or commissioners have the responsibility to assist the chairman in his role. Furthermore, the commission secretariat is headed by a secretary who functions as the Secretary to the Commission and also as the Secretary to the Securities and Exchange Policy Board which guides SECP regarding its functions and facilitates it in formulating policies. It also advises the government on policies and legal matters regarding SECP. It has nine members who are appointed by the federal government. Five members represent each division of the Policy Board. These include (i) Secretary Finance Division (ii) Secretary Law and Justice Division (iii) Secretary of the Commerce Division (iv) Chairman of the Commission and (v) Deputy Governor of the State Bank of Pakistan (SBP). The rest of the four members are chosen from the private sector. Senior management comprises 20 team managers. They perform executive roles to oversee the operations and functions of their respective departments which are under their supervision. The most important organ constituted to oversee and conduct the *Shariah* screening process in the Islamic capital market and the *Takaful* sector is the SECP's *Shariah* Advisory Board (SAB). It has ten members headed by an insurance commissioner who ensures its efficiency. It consists of a chairman with eight members from various backgrounds such as *Shariah* scholars, legal experts, accountants and finance experts along with two members as joint director and a director to represent the SECP. The Secretary to the Commission also acts as the Secretary to the SAB. The functions which SAB must perform are as follows:

- Guide SECP regarding the introduction of *Shariah* compliant products and their developing process as well as facilitate the adoption of *Shariah* standards.
- Harmonize the *Shariah* interpretations and enhance the regulatory and supervisory mechanism of the IFIs and the Islamic capital market of the country.
- To assist SECP regarding the introduction of new rules and regulations intended for creating a smooth supervisory framework for financial products

and services and the productive development of the country's Islamic capital market.

Moreover, SECP has issued its draft for *Sukuk* guidelines and implemented rules and regulations for the *Takaful* sector. It also performs its role in collaboration with SBP for creating a sound Islamic financial system in the country. For this purpose, a mechanism was created to allow the SECP and SBP to collaborate with each other in order to oversee the operational needs of the IFIs. According to this mechanism, a committee was formulated by the Institute of Chartered Accountants of Pakistan (ICAP) under the judgment on Riba (1999) of the *Shariat* Appellate Bench of the Supreme Court of Pakistan in collaboration with SECP and with the support of SBP. The committee revised the AAOIFI's accounting standards in accordance with the country's legal system. After reviewing and transforming the required standards (the AAOIFI standards) according to the legal and operational requirements of Pakistan, ICAP recommended them to be issued by SECP through its statutory notification (SRO) and by SBP through its regulatory directives or circulars. Since its creation, SECP has issued some Islamic Financial Standards for Islamic financial service providers. These standards include the following:

- IFAS-I-*Murabaha*: The standard is applicable to financial statements prepared in the context of historical cost convention in accounting for *Murabaha* transactions undertaken by a bank.
- IFAS-II-*Ijara*: SECP has issued this standard to be followed by *Mudaraba* companies while accounting for *Ijara* (Lease) transactions.
- IFAS-III- Profit and Lost Sharing on Deposit: It was implemented after the SECP's regulatory instruction IBB, 2014.

Although Pakistan's Islamic capital market is not very vast as compared to other countries' market, yet the Islamic finance industry is expanding and diversifying along with the role and responsibilities of SECP. The current size of the Islamic capital market requires an efficient authority to provide regulations in line with the best international practices to bring about sustainable growth and to ensure a harmonized Islamic financial industry. Indeed, the regulatory domains for the SBP and SECP have been explicitly defined and these are banking industry and non-banking and *Takaful* sectors, respectively. However, with the vast expansion of the Islamic finance industry in the form of products, instruments and services, there is a dire need for an exclusive and supreme authority which can oversee the business of the IFIs in a holistic manner. Such an authority would act as a reference body for every aspect of the business of the IFIs in Pakistan.

6. International Standards Setting Organizations for Islamic Finance

International standards setting organizations such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) play an active role in formulating and developing supervisory, governance, accounting and auditing standards for the IFIs in both member and non-member countries. Pakistan has the full membership of these organizations. SBP has officially announced that it will adopt the standards issued by these two organizations to strengthen the supervisory and regulatory frameworks designed for Islamic banking in Pakistan. It is part of what the SBP aims to contribute towards the harmonization of the international Islamic financial system. The rationale of adopting *Shariah* standardization practices of international organizations is to develop a flexible and market-based approach for banking services. It also aims to save the industry from any disruption. Moreover, it is also expected that the adoption of *Shariah* standards will harmonize the local practices with the international *Shariah* compliant and standardized practices. SBP has its own systematic process according to which these standards are adopted and implemented. Firstly, SBP invites the *Shariah* Advisors of the local IBs and other relevant authorities to give their input. It arranges a series of discussions on each required standard. Secondly, in the light of the finalized opinions and conclusions, a set of recommendations is submitted to SAC. At that level, SAC with the consultation of experts from ICAP approves the adoption of the required *Shariah* standards. The SBP issued a circular on January 10th, 2010 announcing that “to harmonize and standardize the *Shariah* practices and procedures of IBIs as per internationally recognized standards, it has been decided that AAOIFI *Shariah* standards will be adopted in a gradual manner, after a detailed review, keeping in view the local legal and industrial requirements in Pakistan.” SBP has also clarified that the adoption of the international standards is to be considered subject to the recommendation of the *Shariah* Advisors of the IBs. It is also explained that this adoption will not be effective in areas where the SBP’s instructions, regulations and guidelines are already available.

According to IBC No. 2, 2008 which provides the Appendix-A-1, the following standards are adopted after certain clarifications and amendments:

- (a) AAOIFI’s *Shariat* Standards No. 3 (Default in payment by a debtor)
- (b) S.S No.8 (*Murabaha* to the purchase orderer)
- (c) S.S No.9 (*Ijarah & Ijarah Muntahia Bittamleek*)

- (d) S.S No.13 (*Mudaraba*) have been revisited and adopted for the IBIs in Pakistan

The adoption method and mechanism are also provided by the SBP in the Appendix-A-1 of the circular. IBIs are given ample time to prepare the operational mechanism for the adoption of the required standards. SBP also states in its directives that failure to comply with the instructions provided by it may invoke penal action under the provisions of the Banking Companies Ordinance, 1962. SBP, from time to time, issues its banking circulars and directives to guide the IBIs regarding the adoption of these standards for banking products and services.

Furthermore, capital market has the authority to regulate and supervise its operations of Islamic financial products and services. In this regard, certain *Shariah* standards of AAOIFI have been adopted including *Shariah* standard No 17, which is applicable to *Sukuk* investment. It covers the *Sukuk* ownership of leased assets, usufructs and services. It also includes *Murabaha*, *Salam*, *Istisna'a*, *Mudaraba*, *Musharkaha*, investment agency and sharecropping, irrigation and agricultural partnerships as defined by the standards. It has been clarified that the standard does not apply to the shares of joint stock companies, certificates of funds and investment portfolios. The said standard is explained through six main clauses including the first clause describing its scope and the last clause describing the issue date of the standard.

Islamic Financial Services Board (IFSB) is the organization which sets the standards for regulations, governance and supervision of the IFIs and recommends them for adoption by the member countries. SBP is a full member of IFSB and does not overlook these standards, rather encourages their adoption. SBP has a specific mechanism for the implementation of such standards. According to this mechanism, in the first step, the proposed standards are revealed to the public in order to record its interest and opinions. Secondly, in the light of the public opinion, the standards are designed. Thirdly, after summarizing and making the necessary evaluation and adjustment according to the local laws and public interest, the respective standards are issued.

There is evidence of the fact that the regulatory directives of SBP have been influenced by the IFSB standards. For instance, in January 2008, SBP issued its guidelines on risk management for the Islamic banking sector. These guidelines were influenced by two sources, that is, SBP's own primary risk management instructions and the "Guiding Principles of Risk Management for Institutions offering Islamic Financial Services" issued by the IFSB. The aim of that move was to enhance the SBP's risk management framework and to recommend different

operational techniques to manage the risks exclusive to the Islamic banking business. It is a set of instructions comprising 15 principles that include an effective risk management mechanism for different kinds of risks such as credit risk, market risk, liquidity risk, operational risk, equity investment risk and rate of return risk. The practice of the management of all these risks with proper examples and their implications for different products and financial instruments are duly explained. Moreover, SBP has taken into consideration the implementation of the IFSB's standard on capital adequacy. For this reason, the first step towards the implementation of the standard is expected to be introduced after an impact assessment study. The report of the impact assessment study will be finalized and the possible issues will be identified. The process will help the industry to be ready for the implementation of the standard in the next stage. This influence became further evident when the *Shariah* Governance Framework for the IBIs of the SBP was introduced. The framework was primarily influenced by the IFSB governance standards titled "Guiding Principles on *Shariah* Governance System for Institutions offering Islamic Financial Services" which is a comprehensive document providing guidelines regarding all aspects of *Shariah* governance for the IFIs.

It has been observed that these organizations do not directly influence the business of the IFIs in Pakistan. Rather, their standards are adopted or implemented after modification by the SBP. However, the adoption of the international *Shariah* standards by the SBP for the Islamic banking sector is expected to have a positive influence on the business of the IFIs. It is also expected that it will further enhance the growth of the industry in line with the international best *Shariah* practices and will also create a secure environment for the Islamic financial system in the country. Although, these organizations have a positive influence on the business of the IFIs in Pakistan; still, it would be more appropriate if the business practices of the IFIs are harmonized through the *Shariah* standards introduced locally by the SAC of the SBP. It will accommodate the business needs of the IFIs and their operations and will holistically improve the regulatory, supervisory and legal infrastructure for the Islamic finance industry in the country.

7. Conclusion and Recommendations

The business of IFIs requires a specific regulatory and supervisory arrangement which is currently evolving in Pakistan. IFIs are yet to be empowered and matured with regulatory, legal and structural enhancements. The present arrangement is far better than the past one which was vulnerable due to legal, regulatory and operational risks. Thus, the government is heavily involved in making policies for promoting the Islamic finance industry. The mechanism of the introduction and

implementation of these strategies and policies is regulated and supervised by the SBP which is the key player in the regulatory practice. However, there are other institutions in the country which also influence the business of the IFIs and impact the supervisory and regulatory arrangements. The highest authority among them which resolves the issues related to Islamic banking and finance is the Federal *Shariat* Court (FSC) which is complemented by the *Shariat* Appellate Bench (SAB) of the Supreme Court of Pakistan. Council of Islamic Ideology (CII) is also entrusted to review and examine the existing laws and advise the relevant authorities on future legislation to ensure conformity with Islamic injunctions. It plays a vital role in transforming the country's financial system into an interest free system through various recommendations. The country's Islamic capital market and IFIs are supervised and regulated by the Security and Exchange Commission of Pakistan (SECP). The business of *Takaful* operations and other non-banking institutions falls under its regulatory domain. The *Shariah* standards issued by international institutions such as AAOIFI and IFSB also have a strong impact on the business of IFIs in Pakistan because SBP and SECP recommend the IFIs to adopt the standards of these cross-border institutions while conducting *Shariah* compliant business operations. The authorities expect that following such standards will enhance the current *Shariah* compliance practice and will harmonize it with the best international practice.

Despite the efforts made by these bodies, it can be observed that the major influence on the business of the IFIs is exerted by SBP and SECP. Hence, the regulatory influence of these authorities is not supreme because the bodies such as FSC and CII also intervene to examine the devising of the regulatory, legal and supervisory measures regarding Islamic banking and finance. Therefore, in order to streamline, harmonize and standardize the business operations of the Islamic banking and finance industry, a sole authority should be appointed which could act as the reference body in this field. It is well-established that the Islamic finance industry is a sophisticated industry which is rapidly growing its business. Therefore, it must be supported with a solid legal and regulatory infrastructure. To implement and monitor these regulations and resolve the issues related to these regulations, there should be a final authority that could be regarded as the reference body in all matters involved in the business of the IFIs. In this regard, the role, scope and jurisdiction of the SAC of SBP ought to be augmented through legal support. These arrangements will not only harmonize and strengthen the business practices of the IFIs, they will also eliminate uncertainty and the overlapping situation regarding the supreme authority specific to the Islamic finance industry. This arrangement can be justified with some alternate solutions. Firstly, a similar

arrangement exists in Malaysia where the national *Shariah* Advisory Council (SAC), which operates under the auspices of Bank Negara Malaysia (BNM), has proved its efficiency. The scope and authority of the SAC of BNM has been supported with a legal framework where the Laws of Malaysia (2009) and the Islamic Financial Services Act (IFSA) spell out its supreme authority. That is why the business operations of the IFIs fall under the jurisdiction of the SAC of BNM, which has to play its supervisory role in order to harmonize the business practices of the IFIs in Malaysia because it has been empowered by the legal and supreme authority to do so. Secondly, to avoid potential systematic disruption in the future, special courts should be established in order to settle the disputes of Islamic finance, instead of referring the cases to FSC which has a wider scope of jurisdiction. In Pakistan, the precedence of special courts is already found in the form of family courts and banking courts, where the cases are heard by specialized judges. Likewise, a special court which must be equipped with judges specialized in Islamic commercial law and its contemporary interpretations, especially with regard to Islamic banking and finance, could be a feasible solution for the issues which may affect the business of the IFIs in Pakistan. Thirdly, since FSC already has a legal foundation, a special bench with qualified judges should be established in it and its role should be confined to settle the issues related to the business of the IFIs, exclusively. It may seem early to consider these recommendations but with the passage of time, the Islamic finance industry will grow further in Pakistan. So, by adopting a proactive approach, a robust solution for the current and future issues is an inevitable option.

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