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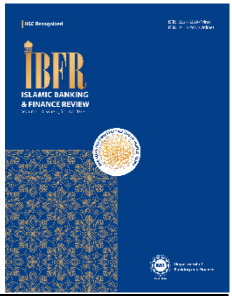

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Islamization of Banks in Pakistan: A review on Challenges and Prospects

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Abstract

Islamic finance has emerged as an important research area for the past few decades especially across the Muslim-majority countries. Pakistan has experienced major transitions towards adoption of a fully Shariah-compliant financial system. The transition also includes changes in regulatory framework. Since the independence of Pakistan, it was clearly described in the objectives of the country that laws would be made in the light of Shariah principles. Efforts to Islamize the banking sector can be traced back to the very first constitutional workings under the Objective Resolution of 1949 to the 26th amendment in the Constitution of 1973 in 2024. Moreover, potential challenges faced by Islamic Banks in Pakistan in the context of social, economic and religious consequences have also been examined extensively by prior studies. This paper aims to provides multiple guidelines by offering a comprehensive review about the regulatory, social, economic and religious consequences of Shariah compliant banking in Pakistan. For this purpose, the constitutional documents and research papers published in peer review journals are reviewed by applying the SPAR-4 literature review methodology. This paper has several valuable theoretical and practical implications as well as research directions for future studies in this field.

***Keywords*:** economic consequences, Islamic banking, Islamic finance, religious consequences, social consequences

Introduction

Islamic Republic of Pakistan has a diverse history of various movements to adopt Islamic laws, which has significantly impacted the country's banking sector. Islamization process, as pursued in Pakistan's banking sector, can be seen as being inspired by socio-political considerations, and an all-embracing project which is worthy of attention(Ali et al., 2023). The reason for making its institutions compliant with Islamic laws particularly the

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banks, is due to this move to practice Islamic laws which can be dated back to the establishment of the country in 1947 (Ahmad et al., 2021). Pakistan's banking system in the last few decades has experienced major transitions from conventional system to Shariah compliant banking in which the Islamic banks practice forbids Riba and perform activities in consonant with the teachings of shariah (Shaikh, 2023). In Pakistan, the process of Islamization of the banks has accelerated in the course of years through certain important decisions, resolutions and legal changes. Among various efforts carried out in the process of Islamic banking, the conversion of the existing conventional system of banking is the most difficult but rewarding step (Ahmad, 2023). These stages of the evolution of the Sharia law implementation in Pakistan include the Objective Resolution of 1949, Constitutional provisions of 1956, 1962 and 1973, Efforts made in the regime of Zia ul Haq, the orders of the Federal Shariat Court of Pakistan in 1991 and 2022 and 26th amendment of 2024.

The emergence of Islamic banking in Pakistan mirrors general tendencies in the development of Islamic banking system as well as Pakistan's specific needs of integrating banking practices with religious norms. Before the 1960s, Pakistan banking industry evolved as a replica of the established western banking system that primarily functioned on the interest-based policy. But in accordance to the objective of Pakistan to be an Islamic state, immense attempts were made to establish and integrate an Islamic banking system that could compete or replace the conventional one (Ahmad, 2023). Different governments in the country, due to the supremacy of the Islamic religion in the nation, have implemented policies that embraced the culture, and over time different reforms have been embraced in the country even in finance. Nowadays, Pakistan has obtained firmly rooted Islamic banking system in its banking structure besides the conventional banking system (Samad, 2024). Currently, several banks including Meezan Bank, Al Baraka Bank, Bank Islami Pakistan and others are fully operating as Islamic banking system, and many other conventional banks have also established Islamic windows to respond to the increasing need of Islamic financial products (Sadiq et al., 2023).

The process of Islamization of Banks in Pakistan is not limited to the changing of sides in the operational balances rather it is a proper process of adapting Islamic teachings, more specifically in the context of banking sector. This process is laden with pragmatic religious, economic and social changes. Religiously, the shift towards Islamic banking fosters the financial practices under the light of Islam, which fits the religious needs of Muslims that consider banking as Halal. Islamic banking being a system of banking, permits the clientele to transact as per the principles of their religion and provides satisfaction in addition to an ethical perspective (Siswanti et al., 2021). This adherence to the provisions of Shariah, which includes the anti Riba, Gharar and Maysir, reduces the divergence between business and faith. In Islamic banks the formula used is equity, partnership, and asset based financing, which are reasonable for the lenders and borrowers, and are socially acceptable (Sadiq et al., 2023). This has made a very large number of people, who were once reluctant to open accounts in conventional banks, to become active participants in the financial system and thus have extended the frontiers of financial inclusiveness.

Prior studies have investigated that the Islamization of banks in Pakistan has led to some important economic consequences in the country that includes the chief strength of Islamic banking being the reduction of high reliance on debt and the provision of more opportunities to share risks and profits, yielding better performance than conventional banking. In contrast with many typical scenarios that involve interest rates setting a priority, with corresponding possibilities for exploitation, Islamic banks work as partners with customers through the system of profit-sharing to minimize financial risks (Awan & Azhar, 2014; Akhtar et al., 2011; Murad et al., 2021; Rashid & Jabeen, 2016). Besides such religious and economic consequences, the process of Islamization of banks highlights social aspects as well. Islamic banking is a form of serving two major causes. One is that it facilitates giving out services to certain groups of the society in the financial realm which they otherwise could not access due to religion. The other is the ethical framework of Islamic banking, non-acceptance of dishonesty and consumers' unfair exploitation creates a bond of trust between the consumers and the financial services provider. Due to the financing of projects that prohibit against investing in vices such as alcohol, gambling and the likes, Islamic banks enhance the welfare of the people and dissuade unhealthy addiction.

Another major aspect is conversion from the conventional banking system to an Islamic banking system which needs a lot of analysis and strict compliance to the Shariah law. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the standard-setting body for

Islamic finance industry, has a special provision for this change in its Shariah Standard #6 (Farooq & Zafar, 2024). The huge contribution of researchers in this field is highly remarkable, but simultaneously it requires a comprehensive review of the above-mentioned circumstances as well as transitions that Islamic Banking in Pakistan has faced, including regulatory, religious, social and economic consequences, by providing an overarching framework that addresses the potential prospects as well.

This study aims to investigate the answer of following research questions:

RQ 1: What are the challenges and prospects for Islamic banks in Pakistan?

RQ 2: What are the futuristic research trends under the Islamic Banking research in Pakistan?

Our research deals with characteristics of Islamic banking in Pakistan since it concerns with the regulatory, religious, economic, and social perspectives for its future development. Whereas the Islamization of Pakistani banks is debated to be a key-mainstream goal since the independence of Pakistan, it is argued that this process has met challenges, which need a better understanding. This paper has analyzed various phases of legal history of Pakistan and aims to establish how each phase has given a unique contribution towards the development of Islamic banking. All these reforms have borne fruits by bringing sweeping changes in the financial practices though the process is full of uncertainties and complexities which are regulatory, operational and interpretive. Nevertheless, a comprehensive systematic review of such regulatory structures, impact of court decisions, and recent constitutional reforms is still scarce, which necessitates undertaking crucial content analysis.

Prior research done in the context of Pakistan on IBI mostly considers parts of the framework, including issues like regulatory environment, Shariah governance, or the societal implication of operating IBI. Nonetheless, none of the works consider an integrated framework proposing the whole array of impacts embracing AAOIFI Shariah Standard for conversion of conventional banks, and the various other impacts of Islamization on Pakistan's broad economical-social context (Awan & Azhar, 2014; Farooq & Zafar, 2024; Zafar & Sulaiman, 2020). This research study seeks to address this gap by making use of available literature including articles and books that cut across the legal, religious and financial domains. Such a review is therefore important in order to look at the current state of Islamic banking in Pakistan, challenges that still remain and future outlook of the sector.

This review paper therefore seeks to fill these gaps by exploring the local regulatory framework of Islamic banking in Pakistan, its consequences (economic, social and religious) and practices. Since this review organizes and synthesizes available literature under the dimensions of Religious (Akbar et al., 2023), Economic (Zulkhibri & Manap, 2019) and Social consequences (Haris et al., 2019), Regulatory requirements (Federal Shariat Court, 2022) and their influences, and Islamic banking practices in Pakistan (Shaikh, 2023), it offers a clear view of the sector's challenges and prospects. In so doing, it hopes to bring out areas that need regulatory interventions, new models, and valuable directions for future research toward framing an inclusive and stronger form of Islamic banking system in Pakistan. This knowledge will benefit policymakers, financial institutions, and academicians by outlining the evaluation intricacies of critical regulatory benchmarks and conversion methods through a content analysis. It will also make clear the current and future possibilities for growth within the industry, identifying areas ideal for creating policies, adopting technology, and increasing awareness about the industry. While filling this knowledge gap, the study will make a significant contribution towards elucidating the issue of setting up a proper Shariah compliant financial system in Pakistan that is informative and usable for the readers.

Review Procedure

This review adopts the SPAR-4-SLR (Scientific Procedures and Rationales for Systematic Literature Reviews) guidelines as outlined by Paul et al. (2021). This approach is particularly well-suited for studies that aim to systematically collect, evaluate, and synthesize scholarly work to generate meaningful insights for future research. The primary aim of this research is to investigate and interpret previous academic and legal literature concerning the Islamization of the banking sector in Pakistan, with specific attention to regulatory evolution, religious compatibility, economic implications, and social consequences.

The SPAR-4-SLR framework offers a structured procedure that enhances the transparency, reproducibility, and academic credibility of the literature review process. The methodology employed in this paper involves multiple sequential steps to ensure the completeness and relevance of the selected literature.

Search Strategy and Data Sources

The initial phase involved an extensive and targeted search for relevant literature across multiple academic databases and search engines, including *Web of Science, ProQuest, Scopus, Google Scholar, Wiley,* and *Emerald*. In addition to academic sources, this review also incorporates *constitutional and legal documents of Pakistan*, which are essential to understanding the evolution of Islamic banking in the national context. These documents include:

- *Objective Resolution (1949)*
- *Constitutions of Pakistan (1956, 1962, and 1973)*
- *Federal Shariat Court (FSC) Judgments (1992 and 2022)*
- *26th Constitutional Amendment (2024)*

The literature search focused on **f***ull-length peer-reviewed articles* written in the *English language*, published from *1980 to 2024*, to ensure both historical and contemporary relevance. The following keywords and search terms were used to capture the thematic scope of the study: *Islamic banking, Shariah compliance, regulatory issues, Islamization of banks, Shari'ah-compliant practices,* and *Islamic finance*.

Results

At the first stage, the comprehensive search yielded a total of *704 articles*. After the removal of duplicate records, *620 articles* were retained for further analysis. This step was crucial in refining the dataset and ensuring that only original and distinct sources were evaluated further.

Screening and Article Selection

The screening process consisted of two stages:

First Screening

This involved excluding articles that did not meet basic inclusion criteria, those not published in peer-reviewed journals or written in languages other than English and those articles that did not focus on the context of Pakistan. This reduced the pool to 585 articles.

Second Screening

A more rigorous screening process was conducted based on thematic relevance to the research questions. Articles were retained only if they addressed one or more of the following: the applicability of Islamic banking regulations in Pakistan, the religious, social, or economic implications of Islamization, or the execution of Islamic banking practices. This stage narrowed the selection down to 63 articles that were both topically relevant and of high academic quality.

Final Assessment and Thematic Categorization

Following screening, a process of article alienation was undertaken to ensure that each selected piece of research paper aligned closely with the core themes of the review. The resulting body of literature provided a robust foundation for synthesizing insights on Islamic banking in Pakistan.

The final set of 63 articles was categorized across several dimensions:

- Regulatory Frameworks
- Religious Consequences
- Economic Implications
- Social Impacts
- Shariah Standards (including AAOIFI)

Regulatory Framework: Establishment and Challenges in Different Regimes

The historical perspective of Pakistan highlighted that the fundamental steps to the Islamic banking system are well entrenched in the ideology and law of Pakistan including Objective Resolution of 1949 and Constitution of 1956 and 1962 etc. These legal movements provided an intellectual basis for an economic system based on Shariah which avoided Riba, and now included elements such as balance, justice and the principle of responsibility in economic transactions. From Zia ul-Haq's staunch Islamization efforts in the 1980s to the establishment of Islamic banking institutions in 2001 and the creation of Shariah Governance Framework by the State Bank of Pakistan, this journey has experienced many regulatory shifts.

Ideological Foundation of Islamic Banking in Pakistan: Objective Resolution 1949

Objective Resolution signed in 1949 holds the strategic position in legal and economic life of Pakistan as it is considered to be the ideological foundation of Pakistan. Enacted soon after the onset of that process, the Objective Resolution outlined the framework on which the future Pakistani governance, including the country's financial structure, would be grounded on. This decree established that Islamic law had to reign supreme in Pakistan because sovereignty lied squarely with Allah. This paper has the potential to be the foundation to champion change for Pakistan's economic system to cohere to an Islamic order.

The post-Purpose of Islamic banking is derived from the resolution which effectively endorses an economic dispensation that is compliant with Shariah. Thus, Objective Resolution gave a clear moral and legal procedure to Islamic values that include a ban to Riba under the principles of justice and equity. The ideological perspective formed a basis to the attempts at Islamizing the Pakistani economy particularly banking system, shaping the beliefs of the policymakers, and driving legal changes. It is for this reason that the Objective Resolution can be said to have defined the starting point of Pakistan's endeavor towards an Islamic financial architecture.

The 1956 and 1962 Constitution: Early Islamic Legal Structures

The Constitution of 1956 was the country's first attempt in establishing a legal framework to be consistent with Islamic principles. It declared Pakistan as an Islamic Republic and included provisions with the aim to align the country's laws with Islamic ideology such as eliminating riba instantly (The Constitution, 1956, p. 7)

The Constitution that promulgated in 1962 was the first systematic endeavor of Pakistan to legally enshrine the Constitutional Progression. The constitution affirmed its Islamic Republic status with Pakistan, further advancing to its polity's interpretation and enforcement of Islamic rules, not excluding the economic sphere. This constitution went further than the Objective Resolution by making it a legal requirement for any law to be compatible with Islamic Shariah law, and for the first time introduced the Advisory Council of Islamic Ideology (CII) as a formal body with the role of advising the government on which laws should be changed in order to give them Islamic Shariah compatibility. Bearing this in mind, the CII was assigned the role of studying Pakistan's financial behavior, proposing changes in the banking sector with a special reference to Riba elimination and the Shari'ah compliant economic activities. Even though the constitution was silent on specific guideline on Islamic banking system, however, it created conditions needed for the growth of Islamic banking due to institutionalization of shariah compliant systems. The CII's interference in advising the government on implementation of Islamic economic practices was a positive move to create a channel through which Pakistan's banking system could be gradually shifted toward an interest-free system.

The 1962 Constitution therefore forms a landmark in the country's drive to Islamise the economy. Crucially, it paved the way to anticipate future initiatives and prepare its own reforms in the banking sector starting with the country's formalization of its commitment to Islamic principles and the establishment of advisory structures. However, the absence of special regulations for Islamic banking within this constitution pointed to the necessity of additional legal instruments for the shift to the Islamic financial system.

Role of 1973 Constitution

The 1973 Constitution laid a significant foundation for the Islamization process after major amendments in the constitution, making it mandatory for all laws to be compliant with the Holy Quran and Sunnah. This constitution strengthened the role of the Council of Islamic Ideology, giving it greater authority to recommend changes in legislation to ensure Shariah compliance.

> The Islamic Council shall consist of such members, being not less than eight and not more than 3[twenty] as the President may appoint from amongst persons having knowledge of the principles and philosophy of Islam as enunciated in the Holy Quran and Sunnah, or understanding of the economic, political, legal or administrative problems of Pakistan. (pp. 228–1973)

Furthermore, this constitution clearly endorsed the prior efforts with inclusion of a provision in its article 38 as follows:

"(f) eliminate riba as early as possible" (38- 1973)

This constitution is the present law of Pakistan, and its strong emphasis on the Islamic principles has influenced multiple aspects of governance of the country, especially those related to the financial sector. The foundational word laid by the 1973 Constitution had later enabled the implementation of Islamic banking laws under future governments.

1992- Federal Shariat Court Judgement on Riba

The judgment declared by Federal Shariat Court (FSC) consisted of the following salient features:

The court explicitly defined Riba as any predetermined interest or premium paid over the principal amount in a loan or debt contract. This prohibition is primarily based on the interpretations of several Quranic verses and Hadiths, which the judgment put as references to provide a reasoning on the prohibition of Riba.

> Those who consume interest will stand ˹on Judgment Day˺ like those driven to madness by Satan's touch. That is because they say, Trade is no different than interest. But Allah has permitted trading and forbidden interest. Whoever refrains—after having received warning from their Lord—may keep their previous gains, and their case is left to Allah. As for those who persist, it is they who will be the residents of the Fire. They will be there forever. (The Quran, 2:275).

In the light of Ahadiths, Riba is strictly prohibited as:

Jabir said that Allah's Messenger (ﷺ) cursed the accepter of interest and its payer, and one who records it, and the two witnesses, and he said: They are all equal. (Sahih Muslim: 1598)

In the light of the above explanation and other comprehensive debate by Islamic scholars and economic experts in FSC it was determined by the court that:

1) Any excess on a loan for a deferred payment, if the borrower fails to repay at the end of the fixed time, and similarly any excess or profit on loan at the time of contract, both are prohibited as riba in the Shari'ah.
2) The alternate banks should be initiated as per the rules of Islamic law to render economic facilities for people.
3) The Academy decided that all the Islamic countries be requested to form banks that will operate according to the principles of Shari'ah to satisfy all the requirements of a Muslim accord. (Riba Judgement, p. 140)

Two profit sharing structures in the light of Islamic Law *Mudarabah* and *Musharakah* were described as primary alternatives to interest-based financing. The shariah verdict explained that in process of *Mudarabah*, an investor provides capital while the *Mudaarib* manages the business, and profits are shared based on a pre-decided ratio. In this mode of financing, losses will be borne solely by the investor. Secondly in *Musharakah* there emerges a joint investment with shared profits and losses, providing a Shari'ah-compliant model for partnerships and equity financing. The judgment also provides guidance for an alternative of leasing; *Ijarah*, as a Shari'ah-compliant model for asset financing, where banks lease assets to clients, receiving rental payments without transferring ownership until the lease terms' end. This model supports asset-backed financing without involving Riba. Moreover, *Istisna* and *Salam* were provided as methods for manufacturing and agriculture financing. The process of *Istisna* allows pre-payment for manufactured goods. While the *Salam* provides advance payment for agricultural products, both of the above-mentioned mechanism is not relied on interest-based financing (Riba Judgement, p. 180–215).

The FSC assigned the State Bank of Pakistan (SBP) the responsibility to oversee and enforce Islamic banking practices across all financial institutions in Pakistan. The court urged the SBP to revise its regulatory framework by removing interest-based provisions and replacing them with such provisions and guidelines that are Shariah Compliant. The FSC provided a phased approach for removing Riba by acknowledging that it requires a gradual shift which is necessary to ensure economic stability of the country.

In the light of above judgment and further proceedings in FSC, the SBP started giving licenses to Islamic Banking Institutions with the aim to gradually transform the banking sector into Shariah compliance in 2002. Afterwards, Islamic Banking sector passed through transitions including gradual adaption of AAOIFI standards and development of Shariah Compliance Framework in the light of FSC Verdict and AAOIFI adapted standards. The transitions include introducing a clear policy for promoting Islamic Banking by SBP (SBP, 2003). In year 2004-08 SBP provided guidelines for Islamic modes of financing on Murabaha, Musharakah, Istisna, Ijarah, Salam and Istisna, and described the definitions of relevant methodologies such as Qard, Wakalah, and Tawarruq (SBP, 2008).

In the year 2010, SBP shifted its strategy of issuing its own Shariah guidelines to adapting AAOIFI standards by defining the objective of adaption as:

> 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 adapted in gradual manner, after a detailed review, keeping in view the local environment and needs of Islamic Banking Industry in Pakistan. (SBP, 2010).

AAOIFI established in 1991 served as a benchmark in shariah compliant standards across all over the world. The institute has issued 54 Shariah standards for Islamic Financial Institutions so far, out of which 37 standards have been adapted by the SBP (SBP, 2024).

Table 1

Name of Standard

SR #	Name of Standard
1	AAOIFI Shariah Standard No. 2 - Debit Card, Charge Card, and Credit Card
2	AAOIFI Shariah Standard No. 3 - Default in Payment by a Debtor
3	AAOIFI Shariah Standard No. 4 - Settlement of Debts by Set-Off
4	AAOIFI Shariah Standard No. 5 – Guarantees
5	AAOIFI Shariah Standard No. 7 – Hawalah
6	AAOIFI Shariah Standard No. 8 - Murabaha to the Purchase Orderer
7	AAOIFI Shariah Standard No. 9 - Ijarah & Ijarah Muntahia Bittamleek
8	AAOIFI Shariah Standard No. 10 - Salam and Parallel Salam
9	AAOIFI Shariah Standard No. 11 - Istisna'a and Parallel Istisna'a
10	AAOIFI Shariah Standard No. 12 - Sharika (Musharaka) and Modern Corporations Shariah Standard - Sharikat ul Milk and Diminishing Musharakah (based on Sharikat ul Milk)
11	AAOIFI Shariah Standard No. 13 – Mudaraba
12	AAOIFI Shariah Standard No. 14 - Documentary Credit
13	AAOIFI Shariah Standard No. 15 - Ju'alah

SR #	Name of Standard
14	AAOIFI Shariah Standard No. 16 - Commercial Papers
15	AAOIFI Shariah Standard No. 17 - Investment Sukuk
16	AAOIFI Shariah Standard No. 18 - Possession (Qabd)
17	AAOIFI Shariah Standard No. 19 - Loan (Qard)
18	AAOIFI Shariah Standard No. 22 - Concession Contracts
19	AAOIFI Shariah Standard No. 23 - Agency and the Act of an Uncommissioned Agent (Fodooli)
20	AAOIFI Shariah Standard No. 24 - Syndicated Financing
21	AAOIFI Shariah Standard No. 25 - Combination of Contracts
22	AAOIFI Shariah Standard No. 28 - Banking Services in Islamic Banks
23	AAOIFI Shariah Standard No. 34 - Hiring of Persons
24	AAOIFI Shariah Standard No. 36 - Impact of Contingent Incidents on Commitments
25	AAOIFI Shariah Standard No. 37 - Credit Agreement
26	AAOIFI Shariah Standard No. 38 - Online Financial Dealings
27	AAOIFI Shariah Standard No. 39 - Mortgage and Its Contemporary Applications
28	AAOIFI Shariah Standard No. 42 - Financial Rights and How They Are Exercised and Transferred
29	AAOIFI Shariah Standard No. 45 - Protection of Capital and Investments
30	AAOIFI Shariah Standard No. 46 - Al-Wakalah bi Al-Istithmar (Investment Agency)
31	AAOIFI Shariah Standard No. 48 - Options to Terminate Due to Breach of Trust (Trust-Based Options)
32	AAOIFI Shariah Standard No. 49 - Unilateral and Bilateral Promise
33	AAOIFI Shariah Standard No. 50 - Irrigation Partnership (Musaqat)
34	AAOIFI Shariah Standard No. 51 - Options to Revoke Contracts Due to Incomplete Performance
35	AAOIFI Shariah Standard No. 52 - Options to Reconsider (Cooling-Off Options, Either-Or Options, and Options to Revoke Due to Non-Payment)

SR #	Name of Standard
36	AAOIFI Shariah Standard No. 53 - 'Arboun (Earnest Money)
37	AAOIFI Shariah Standard No. 54 - Revocation of Contracts by Exercise of a Cooling-Off Option

2022- Federal Shariat Court Judgement on Riba

In recent developments, the FSC issued another important verdict in 2022, this verdict reaffirmed the prohibition of Riba and directed the government of Pakistan to accelerate the transitional process towards full implementation of Islamic banking system. This ruling emphasized that the elimination of interest from financial sector is not only a religious obligation but it is an economic necessity too. The court argued that interest-based financing ultimately contributes to economic inequality in the society.

Referring to the previous verdict of FSC in 1992, the court firmly made a distinction between Riba and Profit. In the light of Islamic rules, Riba was considered as exploitative and strictly prohibited element in Islam due to its adverse effects of financial and social inequality. Several Islamic scholars and Islamic institutions including Islamic Fiqh Academy endorsed that all forms of interest equate to Riba and therefore are not permissible in Islam. This strong emphasis was placed on the basis of the rationale that Riba contributes in promoting economic disparities, concentrating the wealth in the hands of a few, which directly contradicts the Islamic basis of equitable distribution and social welfare (FSC Judgment, 2022, p. 238–241).

This judgment outlined the main Shariah compliant financial practices, alternative to conventional banking which include Murabaha, Ijarah, Mudarabah, Musharakah etc. Economic experts and scholars strongly debate for these mechanisms and their practical nature of applicability eg., SUKUK investment options of Meezan Bank etc. (FSC Judgment, 2022, pp. 215–220).

This judgment provided every single base relevant to the movements that contributed towards this transition process including “Section 22 of the SBP Act, 1956”, this act previously allowed interest-based transactions, which has been amended to eliminate "interest" deliberately. The revised act now facilitates Islamic banking. Furthermore, different financial regulations such as the banking companies’ ordinance and other related acts are declared as repugnant to Islamic injunctions and now, they are revised as a support to a Riba-free economy (FSC Judgment, 2022, pp. 270–275).

Contrary to previous efforts and constitutional amendments in support of Islamic Banking, this verdict demanded a clear timeline for the implementation of Islamic Banking system in Pakistan. It was followed by detailed arguments related to the current scenario of the economy of the country. Primarily, it was related to the outstanding payments and interest to various international institutes by our country including IMF, and CPEC financing on the basis of interest base principles.

This resulted in Pakistan to converting its international borrowing to Shariah Compliant modes. Some of these options include:

a) Regular issuance of International Sukuk

b) Islamic Project Financing / Infrastructure financing based on Musharakah, Ijarah & Diminishing Musharakah

c) Commercial financing from International Bank using Murabaha and Commodity Murabaha structures

d) Working Capital & Trade Finance lines on Murabaha & Salam.

e) Conversion of existing financing like China Pakistan Economic Corridor (CPEC) to Islamic mode. (FSC Judgment, 2022, pp. 240–249)

Finally in the judgment FSC directed the government to fully implement the Riba-free financing in the financial sector of Pakistan by the end of December 2027, stating the five-year period as a sufficient time to implement this transition completely (FSC Judgment, 2022, p. 296).

26th Amendment 2024

In the continuity of the transformation of financial sector towards Shariah compliant principles, it was further endorsed by the national assembly of Pakistan by reaffirming the deadline given by FSC in 2022 to eliminate the Riba completely before January 2028.

Religious, Economic and Social Consequences

The existing literature highlighted a range of economic, social and religious implications of Islamic banking in Pakistan. However, these impacts are interdependent, the sector in question affects many dimensions of society and economy.

Religious Consequences

The impact of Islamic banking on religion goes with compliance of Shariah principles and the perception of religious legitimacy basis. Islamic banking is done in compliance with the Shariah directives (i.e., Shariah law) such as Prohibition of Riba and business trades being limited to halal principles. The existence of Shariah advisory board also gives an assurance of the correct banking operations which are in accordance with Islamic law (Bhatti et al., 2024). That adherence is crucial for preserving consumer trust in Islamic financial products. Some customers and scholars remain skeptical despite the efforts of the sector to offer Shariah compliant products. An ambiguity over authenticity of Islamic financial products is created due to the perception that they are not sufficiently different from conventional banking instruments (Khan & Bhatti, 2008). One side of this challenge, therefore, highlights the necessity of improvements in Shariah governance that are ongoing, as well as the need for more innovative, truly Islamic financial products.

Economic Consequences

Islamic banking can uniquely help improve financial stability, economic growth and equity, even though, there exist challenges such as the liquidity management and limited available Shariah compliant financial instruments.

Throughout their history, Islamic banks in Pakistan have been resilient through financial downturns: through asset backing financing models and risk sharing. Take, for example, their avoidance of interest-based derivatives during the global financial crisis. Islamic banks showed less exposure to toxic assets than conventional banks largely because of their avoidance of interest-based derivatives. However, the imperfections in liquidity management result from the dearth of Shariah-compliant instruments which limit the ability to meet immediate financial obligations. Profit and loss sharing (PLS) contracts are used by Islamic finance to encourage economic growth by making financing forthwith join with real economic activities. Nevertheless, debt derivative such as Murabaha form the bulk of Islamic banking transactions. An inclination toward debt-based structures limits the potential for Islamic finance to realize its potential power to spur economic growth (Bhatti et al., 2024). More equity based financial products could unlock the potential for growth in the sector.

Social Consequences

The social implications of Islamic banking are the promoting efforts of financial inclusion as well as ethical finance. But there are awareness and accessibility challenges that can actually constrain their actual social impact.

Islamic banking is looking to bring those segments of the population that shun conventional banking on religious grounds into the financial systems. The sector has provided a platform to help underserved communities through the offering of microfinance and small business financing in accordance with Islamic principles (Ahmad et al., 2011). It also fits the ethical roots of Islamic finance, rooted in social justice and economic equality. Islamic Banks also conduct social welfare projects and ethical financing that, if so, can generate social equity. Yet the impact to the sector is constrained by the scarce awareness of Islamic financial products amongst people. However, many customers still see Islamic banking as a niche market, negatively impacting its adoption and its broader social impact (Hussain et al., 2021).

Discussion

The Challenges in Implementation of Islamic Banking

The process of transforming the banking system in Pakistan into an Islamic system has faced a number of challenges that slowed down the process. As highlighted in this review some of the challenges include insufficient legal and regulatory structures. Islamic banking is not only different from the conventional banking in terms of products, services and processes but has entirely different parameters. This calls for the establishing of new legal frameworks especially in acknowledgement of Islamic financial transactions. The State Bank of Pakistan (SBP), for instance, takes a critical part in this situation, as described earlier, to regulate and standardize Islamic finance products. However, they noted some challenges: inadequate compliance with regulations, non-harmonization of Shariah, and the shortage of a coherent structure for Islamic financial institutions are still obstacles to the sector's development.

However, cultural and social factor also present obstacles to the Islamization process, currently, as Pakistan is an Islamic country, but its public is still not well informed about Islamic banking and finance (Art 1 Social). As postulated by papers in the literature, one reason why the use of conventional banking procedures and most Islamic financial services remain limited is due to the numerous questions the public has, and their distrust in embracing new structures in the financial industry. (Social 2) There is also some level of push back from conventional banks as they move from an interest model to one that is prohibited from charging Riba (Social 3). This is further bolstered by economic considerations where conventional banking institutions that have principally operated from the gains on interest are apparently averse to changing their business model to what is risk-sharing and profit and loss sharing inherent in Islamic banking.

Implications of Islamic Banking in Economic Context

One of the key principles within Islamic banking and the overall Islamic financial system that does prove problematic on a practical level is risk sharing principle. This paper noted that Islamic banks need to provide Islamic financing solutions that include contracts such as Mudarabah (profit sharing), and Musharakah (partnership financing contracts with sharing of risks and rewards). It's important to note that whilst operationally, these models are ethical, they depend on drastic levels of understanding and trust between the financier and the borrower. In practice this is not as easy to achieve since most Islamic banks do not have efficient risk management systems, there is limited financial sophistication and Islamic banking professionals know little of the exotic Islamic finance products. The problem with risk management in Islamic banks is that they experience considerable challenges in addressing the risks related to profit and loss sharing features of the models and in the implementation of the models.

This paper therefore, seeks to understand that the process of Islamization in banking sector in Pakistan i not only a change of name but a real change of economy as well. In the literature, it has been opined that Islamic banking holds the key to the financial misery of the underprivileged as well as the poor. Micro financing is one of the important branches of Islamic finance and it is being spread as the better option to interest charging contract that is highly derogatory to the poor. (Eco Art 3,4) Islamic micro financing is defined as the provision of small-scale financing for those people who are excluded from conventional or formal financing system without being forced to pay higher cost of financing. The review paper pointed to models of micro financing in Islamic AFIs including the First Microfinance Bank and U Microfinance Bank in Pakistan. These institutions have shown how effective Islamic banking can be as far as progressive contribution to the social fabric is concerned (Eco 4,5,7).

Shariah Compliance and Consumer Trust

In addition, in the light of review of previous literature, the major problem as to why Islamic banking has not progressed is because it receives inadequate support and incentives from the government (Soc 4). The government has not shown interest in promoting fiscal and monetary policies that further the operations of the Islamic banking. As evident with SBP's policy measures to support Islamic banking, the provincial government's relatively puny non-financial support of Islamic institutions, along with a lack of regulatory certainty, holds the sector back from achieving its full potential.

Basically, about one fourth of the literature focused on how Shariah compliance has impacted the development of Islamic banking in Pakistan. Islamic banks are under obligation to follow all the principles of Shariah law and this surveillance is done by a Shariah Supervisory Board (SSB) of the bank (FSC, 2022, Relg Consq 1). The literature also suggested that Shariah compliance is the most important competitive factor of the Islamic banks, given its appeal to the religious consumers in the financial markets. However, as discussed in the earlier part of this paper, one of the key success factors pertains to consumer trust in related Shariah-compliant products. Lack of trust in conventional banking in Pakistan has been a reason for slow growth of the Islamic finance and a large number of consumers are in doubt about the existence of non-interest-bearing products at Islamic banks.

Furthermore, as the review has mentioned, institutional Shariah compliance is mixed, and there are instances when some Islamic banks are found to be out of the Islamic law standards. Shariah arbitrage, which involves banks taking advantage of legalities interpolated in Shariah compliance, is a way of eroding the public confidence in Islamic Banking. This causes distressing consequences to the future stability of the Islamic banking system in Pakistan because public trust is pivotal to the success of the industry.

Conclusion

The process of transforming the banking system in Pakistan into an Islamic system has faced a number of challenges that slowed down the process. As highlighted in this review some of the challenges include insufficient legal and regulatory structures. Islamic banking is not only different from the conventional banking in terms of products, services and processes but has entirely different parameters. This calls for the establishing of new legal frameworks especially in acknowledgement of Islamic financial transactions. The State Bank of Pakistan (SBP), for instance, takes a critical part in this situation, as described earlier, to regulate and standardize Islamic finance products. However, they noted some challenges: inadequate compliance with regulations, non-harmonization of Shariah, and the shortage of a coherent structure for Islamic financial institutions are still obstacles to the sector's development.

Future Research Directions

Regulatory Framework Development

Although the current literature involves the issue of regulation in the context of Islamic banking in Pakistan, there is scant information on the nature of the regulatory framework for the development of unified Islamic finance system. Research should extend to formulating a proper legal framework to cater for the needs of Islamic banking industries in a way that the markets will blend with the international financial markets. A comparative analysis of the Islamic finance rules with other Muslim dominated countries like Malaysia or Saudi Arabia could offer insight to Pakistan to identify what measures it has to undertake to improve the protocols on Islamic finance.

Demand of Islamic Banking Products and Consumer Behavior

The issues that lie in another future research substratum are the demand side of the Islamic banking. While the banking system of Pakistan has started to incorporate the principle of Islamic banking, it is still in its embryonic stage. Research papers focusing on the factors affecting consumer behaviour while choosing the Islamic banking products would be useful for this research. Subsequent studies can examine religious attitude, awareness, perceived benefits regarding IF and its influence on the consumers' decisions. Marketing research in the context of market segmentation could reveal features of specific consumer segments that would allow presenting Islamic banking as an attractive proposition.

Islamic Banking and Fin-Tech

Given the growing popularity of fintech and digital banking there is an opportunity to use modern financial technology coupled with Islamic finance. Further research includes future direction of Islamic fintech in Pakistan including digital payment system, peer-to-peer lending, and use of blockchain technology. Following the development of Islamic finance technologies, which are compatible with Shariah standards, is likely to go a long way in advancing acceptance of the new technology, especially by young users. Research work in relation to Islamic finance through digital platforms could assist banks in developing innovative products that are also Shariah-compliant in today's fast-growing technological society.

Socio-Economic Impacts

Although, there has been some attempt on the analysis of macroeconomic effects of Islamic banking, more micro and macroeconomic impact of Islamic banking on poverty, financial, and economic development in Pakistan still remains a research agenda. Subsequent studies can measure the degree to which Islamic finance has made positive impact on the rate of financial exclusion in the targeted groups especially in the rural areas. Using case studies of Islamic microfinance institutions can give a better insight on how Islamic banking can be used for improving the social as well as economic-enablement and economic stability.

Shariah Compliance

As earlier stated, the issue of Shariah compliance is one of the key determinants of the success of Islamic banking. However, further research investigation or case studies of the actual implementation of the Shariah principles in the Islamic banks seems to be lacking. Scale research should be directed on the question of the degree of standardization of the mechanisms of adherence to Shariah, the work of Shariah boards, and the use of Shariah governance in the work of banks. Further, it is necessary to investigate the practices concerning the internal auditing of shariah compliance more so as to guarantee the conduct of such assertions throughout the sector.

Conflict of Interest

The authors of the manuscript have no financial or non-financial conflict of interest in the subject matter or materials discussed in this manuscript.

Data Availability Statement

The data associated with this study will be provided by the corresponding author upon request.

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