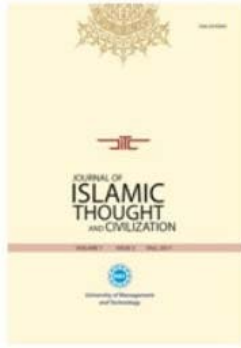


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## Regulatory Challenges of Islamic Banking in Pakistan

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### Abstract

This research investigated the regulatory challenges faced by Islamic banking from the perspective of Islamic bankers in Pakistan. The data were collected through cross-sectional survey using a questionnaire from 152 bankers, selected through stratified convenient sampling, working at different Islamic banks of Lahore. The mean scores for overall 68 statements as well as for its sub-dimensions, namely, 'Scope of Regulatory Authorities,' 'Development Issues with Regulatory System,' 'Licensing and Authorization,' 'Shari'ah Supervision,' 'Supervisory Framework,' 'Institutional Harmonization,' 'Information Disclosure,' 'Market Development' and 'Capacity Building' indicated the agreement of Islamic bankers with pre-formulated list of regulatory challenges for Islamic banking. There was no statistically significant difference in bankers' perceptions with regard to regulatory challenges for Islamic banking based on gender and nature of bank. However, the participants' qualification, professional experience, and career levels appeared to be correlative of Islamic bankers' perceptions regarding regulatory challenges for Islamic banking. The findings are helpful for policy makers to make strategic decisions for the development and growth of IB in Pakistan. This study comprises pragmatic insights of Islamic bankers and benefits both Islamic as well as other conventional banks adopting Islamic banking in order to increase their business opportunities. In addition, the results of this study may assist the policy makers and regulators in policy formulation regarding Islamic banking in Pakistan.

**Keywords:** Islamic banking, Islamic finance, challenges, regulations, Pakistan

### Introduction

There is a viable growth in the industry of Islamic banking (IB) since its inception in Pakistan.<sup>1</sup> Therefore, a serious debate about the stability of IB is in discussion in Pakistan and around the globe. As per the report by INCEIF,<sup>2</sup> assets of Islamic finance have reached USD 2.4 trillion, in which the share of IB is USD 1.8 trillion that is about 12% of conventional banking globally. There are nine core markets offering IB products and services including Bahrain, Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, Turkey, Kuwait and Pakistan, respectively.<sup>3</sup>

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<sup>1</sup>State Bank of Pakistan, *Strategic Plan: Islamic Banking Industry of Pakistan 2014-18* (Islamic Banking Department, State Bank of Pakistan, 2014).

<sup>2</sup>INCEIF, 2014<<http://www.inceif.org/industry-growth/>>

<sup>3</sup>*World Islamic Banking Competitiveness Report, New Realities New Opportunities* (Ernst and Young Limited, 2016).



The challenge in IB varies due to its transformational phase of development and parallel exercising with conventional banking (CB). A significant difference in IB and CB remains in methodology owing to the offering of financial services with or without interest. Due to this difference of methodology, the importance of regulators maximises regarding quality assurance under a strong regulatory setup that is in line with the principles of Islamic law and to achieve the true objective of Islamic banking.<sup>4</sup> Hawary, Grais, and Iqbal<sup>5</sup> showed their concern regarding the clarity of IB rationale to pursue the Islamically sanctioned business activities and to regulate the policies of Islamic banking as per the Islamic law. Khattak and Rehman<sup>6</sup> emphasized the need of a competitive economic system equally suitable to satisfy the financial needs of Muslim and non-Muslim community.

Pakistan is a developing country with a huge Muslim population. It has been ranked on the ninth position in terms of Islamic banking considerations and developments. The total asset of Islamic banking has been reported to be at 10.4% of the total Pakistani finance whereas 1.4% of the world finance.<sup>7</sup> In Pakistan, State Bank of Pakistan (SBP) is a prestigious regulatory body taking care of overall banking protocols including IB and CB under different units. Conflict with governing regulations may rise, if there are ambiguities in appropriate instructions for banking service providers and other stakeholders of IB. Furthermore, it may jeopardise the IB sustainability in future. An extensive search for literature on issues about IB indicated a small amount of research which investigated barriers with service quality,<sup>8</sup> customers' satisfaction, perception of users and non-users,<sup>9</sup> IBF controversies,<sup>10</sup> operational and institutional barriers<sup>11</sup> mainly.

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<sup>4</sup>State Bank of Pakistan, *Strategic Plan* (2014).

<sup>5</sup>El Hawary Dahlia, Wafik Grais, and Zamir Iqbal, *Regulating Islamic Financial Institutions: The Nature of the Regulated* (World Bank Policy Research Working Paper, 2004), 49.

<sup>6</sup>Naveed Azeem Khattak and Kashif-ur-Rehman, "Customer Satisfaction and Awareness of Islamic Banking System in Pakistan," *African Journal of Business Management* 4, no. 5 (2010): 662-671.

<sup>7</sup>*World Islamic Banking Competitiveness Report, New Realities New Opportunities* (Ernst and Young Limited, 2016).

<sup>8</sup>Mohammed N Chaker, and Jabnoun Naceur, "Barriers to Service Quality in Islamic Banks in Qatar," *International Journal of Commerce and Management* 20, no. 4 (2010): 296 - 307.

<sup>9</sup>Irfan Butt, et.al. "Barriers to Adoption of Islamic Banking in Pakistan," *Journal of Islamic Marketing* 2, no. 3 (2011) 259-273; Abdul Malik Mirza, and Abdel-Karim Halabi, "Islamic Banking in Australia: Challenges and Opportunities," *Journal of Muslim Minority Affairs* 23, no.2 (2003).

<sup>10</sup>Muhammad Shaukat Malik, Ali Malik, and Mustafa Waqas. "Controversies that Make Islamic Banking Controversial: An Analysis of Issues and Challenges," *American Journal of Social and Management Sciences* 2, no. 1 (2011): 41-46; Mohammad, Mansoor Khan and M. Ishaq Bhatti, "Why Interest-Free Banking and Finance Movement Failed in Pakistan," *Humanomics* 22, no. 3 (2006): 145-161.

<sup>11</sup>Abdul, Malik Mirza, and Abdel-Karim Halabi, "Islamic Banking in Australia" (2003); Md. Abdul Awwal Sarker, "Islamic Banking in Bangladesh: Performance, Problems and Prospects,"



A perusal of published research indicated that no study appeared to have been conducted investigating the regulatory challenges for Islamic banking in Pakistan directly. There was a need to conduct research on this issue which was frequently reported in the previous researches. Therefore, the current research seeks to investigate the view of Islamic bankers with regard to regulatory challenges of IB in Pakistan, since Islamic banking is rapidly growing and holds great potential in Pakistani banking sector.

### 1.1 Research Objectives

- To determine the regulatory challenges of Islamic banking in Pakistan as perceived by the Islamic bankers.
- To find out the nature of association between the Islamic bankers' perceived regulatory challenges and demographic variables such as gender, qualification, professional experience, career levels, and bank type.

## 2. Literature Review

A number of studies have been conducted to investigate the challenges facing Islamic banking. of those studies, the study of Al-Omer and Abdel-Haq<sup>12</sup> emphasized the phenomenology of IB. Primarily, it is the elimination of *Riba* but unfortunately the absence of qualified professionals is causing delays in methodology, product innovations and financial engineering to reflect the true objectives of IB. The researchers stated a number of factors hindering the performance of Islamic banking as political instability, economic conditions causing lack of consensus on concerned policies and its association with the well-being of the people. Omer and Abdel suggested the revision of structural policies regarding institutional capacity, trainings, incentives, enforcement, systematic legality of reform, and social acceptance. Chaker and Jabnoun<sup>13</sup> investigated the obstacles in improving the service quality of Islamic banks in Qatar. The results indicated that the lack of service quality was due to the lack of empowerment and transformational leadership.

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*International Journal of Islamic Financial Services* 1, no.3 (1997); Muhammad Z. Mamun, "Prospects and Problems of Islamic Banking from Bank's Perspective: A Study of Bangladesh," Paper presented at the 8th International Conference on Islamic Economics and Finance (2011); Rodney Wilson. "Challenges and opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience," *Islamic Economic Studies* 7, no. 1 and 2 (2000): 35-59; Abdul Malik Mirza, and Abdel-Karim Halabi, "Islamic Banking in Australia," (2003); Munawar Iqbal, Ausaf Ahmad, and Tariqullah Khan, *Challenges Facing Islamic Banking*, Occasional Paper No. 1: (Islamic Research and Training Institute and Islamic Development Bank, 1998).

<sup>12</sup>Faud Al-Omer, and Muohammed Abdel-Haq, *Islamic Banking Theory Practice and Challenges* (London: Zed Books, 1996).

<sup>13</sup>Mohammed N Chaker, and Jabnoun Naceur, "Barriers to Service Quality," (2010): 296-307.



Karbhari et al.<sup>14</sup> investigated IB problems in UK through interviews of senior practitioners from financial institutions. The results indicated that Islamic banking is much lower than its potential due to the absence of Islamic financial regulators and the public is unable to understand what constitutes Islamic banking. Wilson<sup>15</sup> reported the demand of *Shari'ah* compliance financial services as hub of foreign exchange financial services. Wilson recommended that the branding of Islamic financial products is required to attract British people. A study of Mirza and Halabi,<sup>16</sup> Ahmad and Hassan<sup>17</sup> examined the activities and operations of two Islamic financial institutions (MCCA and MCCU). They hypothesized that *riba*-free banking is likely to flourish in Australia in the future. They described that the performance of Islamic banking in Australia is at a lower level because Muslims are in minority there. They argued for the demand of Islamic banking due to its *Shari'ah* ruling principles, justice in financial transactions and equity in society for better harmonization. They also found out that weak regulatory standards are a huge impediment for the growth of Islamic banking in Australia. Ahmad and Hassan<sup>18</sup> examined the legal and regulatory practices of Islamic finance particularly with regard to the compliance of Islamic Financial Services Providers (IFSP) in Australia. They discussed the importance of regulatory regimes for account holders and masses at large, ensuring compatibility with *Shari'ah* law for system effectiveness. Unfortunately, in Australia there is no independent system that ensures *Shari'ah* compliance. The pace of Islamic banking is slow due to the weak understanding of *Shari'ah* law and the influence of western traditional financing. They recommended the presence of *Shari'ah* supervisory board to introduce sound and transparent frameworks to increase the practice of Islamic banking in Australia. They suggested that the agenda to strengthen Islamic banking should be highlighted in parliament so that legislations to offer Islamic financial services could be introduced at a higher level. They further recommended that Muslim community of Australia could be attracted by the offering of retail and investment facilities and educating people regarding Islamic financial services.

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<sup>14</sup>Yusuf Karbhari, Kamal Naser, and Zerrin Shahin, "Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK," *Thunderbird International Business Review* 46 (2004): 521 – 543.

<sup>15</sup>Rodney Wilson, "Challenges and Opportunities" (2000): 35-59.

<sup>16</sup>Abdul Malik Mirza, and Abdel-Karim Halabi, "Islamic Banking in Australia," (2003).

<sup>17</sup>Abu Umar Faruq Ahmad, and M. Kabir Hassan, "Regulatory Challenges and Opportunities: A Case of Australia," *Paper Presented at the Practitioner Symposium - Islamic Financial Services: What Role for Australia?* Melbourne, 2009b.

<sup>18</sup>Abu Umar Faruq Ahmad, and M. Kabir Hassan, "Legal and Regulatory Issues of Islamic Finance in Australia," *International Journal of Islamic and Middle Eastern Finance and Management* 2, no.4 (2009a): 305-322.



Kinyanjui<sup>19</sup> determined the challenges facing the development of Islamic banking in Kenya through surveying 33 customers and 11 bank managers. The results showed that the absence of *Shari'ah* compliant legal system was a major hurdle for low market penetration. The bank managers showed the ambiguity regarding institutional policies for *Shari'ah* compliant banking. There was a need for expansion in *Shari'ah* compliant financial services for IB penetration in the Kenyan market.<sup>20</sup>

In Iran, the qualitative study of Seyed-Javadin et.al<sup>21</sup> discovered inadequate supervision, less determination by executives, less awareness in public, less attention to product innovation and engineering, risk aversion instead of risk taking, limited investment avenues and lack of linkages among international markets as major factors hindering IBF performance. Malik, Malik, and Mustafa<sup>22</sup> reported the challenges of *shari'ah* interpretation from the view of different school of thoughts. This study suggested the need of harmonization with regard to *Shari'ah* interpretation, encouraged the AAOIFI role for *Shari'ah* standardization worldwide, and the presence of qualified professionals having knowledge of both conventional banking and Islamic laws to ensure best practices of IB. More transparency in regulations, accountability and monitoring for *Shari'ah* auditing and efficient mechanism for liquidity management are required for stable Islamic financial markets.

Mamun<sup>23</sup> explored the challenging factors affecting the performance of Islamic banks in Bangladesh using 100 respondents from 47 banks (Islamic and conventional). The results indicated a need for *Shari'ah* compliance financial services to attract the people. It was also found that political interventions were contributing towards debts gain. In addition, post financing services were highly required to retain customers and for the enhancement of their loyalty. An exclusive regulatory system for Islamic banking in Bangladesh was recommended. The aspects needed to be improved for the growth of IB included availability of supportive legal framework, adequate interbank money market, institutional linkages, trainings for staff

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<sup>19</sup>Shamim Njeri Kinyanjui, "Challenges Facing the Development of Islamic Banking. Lessons from the Kenyan Experience," *European Journal of Business and Management* 5, no. 22(2013): 94-102.

<sup>20</sup>Ahamed Lebbe Abdul Rauf, "The Challenges and Opportunities for the Islamic Banks in Non-Muslim Countries"

<sup>21</sup>Seyed Reza Seyed-Javadin et.al, "An Explanatory Analysis to Identify and Prioritize the Challenges of Islamic Banking Implementation: The Case of I. R. Iran," *International Letters of Social and Humanistic Sciences* 35 (2014): 45-55.

<sup>22</sup>Muhammad Shaukat Malik, Ali Malik, and Waqas Mustafa, "Controversies that Make Islamic Banking Controversial: An Analysis of Issues and Challenges," *American Journal of Social and Management Sciences* 2, no.1 (2011): 41-46.

<sup>23</sup>Muhammad Mamun, "Prospects and Problems of Islamic Banking from Bank's Perspective: A Study of Bangladesh," *Paper Presented at the 8<sup>th</sup> International Conference on Islamic Economics and Finance* (2011).





development and improvement in service quality. The study of Sarker<sup>24</sup> analysed the performance and efficiency of banking (Islamic and conventional) in Bangladesh. He argued that an optimistic outcome will appear when Islamic banks will be treated as the sole economic system in the country. There was a need for the improvement of profit-loss sharing (PLS) mechanism, operationalizing legal framework, and standardization of product development and instruments. Perves<sup>25</sup> reported that the lack of short term investment avenues, inter-bank money market, less compatibility of IB standards with *Shari'ah* law, less trained staff, weak presence of full-fledge Islamic banks and weak corporate governance as the major hurdle for the development of IB in Bangladesh. Another study by Ahmad and Hassan<sup>26</sup> investigated the issues of the regulatory system of IB in Bangladesh. The results revealed that Islamic banks were more inclined toward short term commercial activities with weak legal support instead of maintaining systematic progress. They highlighted the need of standardization in financial activities and innovation based on *Shari'ah* principles, establishment of secondary market, and improved reporting disclosure to support banks and customers.

In Pakistan, several researches reported the challenges that needed to be overcome and required the attention of stakeholders particularly at regulatory level and would be helpful to channelize the service sector of Islamic banking adequately and effectively. Iqbal, Ahmad, and Khan<sup>27</sup> identified a number of challenges for Islamic banking in Iran, Sudan and Pakistan by focusing on corporate banking environment and developments over the last few decades. The findings revealed that the globalization of Islamic banking is yet too small to play a significant role in socio-economic internationalization of foreign and domestic markets by the Islamic banks. They highlighted a serious concern as, "If Islamic banking is not perceived to be "Islamic," it will not be long when the existing Islamic banks will lose much of their market."<sup>28</sup> This study indicated a need of product innovation to make Islamic banking stable in alternate markets. The lack of trained manpower also raises the question about the authenticity of information, products service quality and delivery in all aspects. The supervision of Islamic banks under autonomous supervisory and regulatory parameters is also crucial to ensure the true understanding of Islamic financing industry. Limited branch network, limited understanding about the

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<sup>24</sup>Md. Abdul Awwal Sarker, "Islamic Banking in Bangladesh: Performance, Problems and Prospects," *International Journal of Islamic Financial Services* 1, no. 3 (1997):1-21.

<sup>25</sup>Mohammad Masud Perves, "Legal and Regulatory Framework in Islamic Banking System: Bangladesh Perspective," in *European Journal of Business and Management* 7, no. 21 (2015):179-187.

<sup>26</sup>Abu Umar Faruq Ahmad, and M. Kabir Hassan, "Regulation and Performance of Islamic Banking in Bangladesh," *Thunderbird International Business Review* 49, no. 2 (2007): 251-277.

<sup>27</sup>Munawar Iqbal, Ausaf Ahmad and Tariqullah Khan, "Challenges Facing Islamic Banking," Occasional Paper no.1 (Islamic Research and Training Institute and Islamic Development Bank, 1998).

<sup>28</sup>Munawar, Ausaf, and Tariqullah, "Challenges Facing Islamic Banking," 48.



principles of Islamic banking, and the lack of provision in financial services are major barriers in the adoption of Islamic banking in Pakistan.<sup>29</sup> Tahir<sup>30</sup> described that the lack of standardization with regard to vocabulary (users' knowledge about words), ambiguity in financial reporting and the calculation of formulas against each product offered as particular issues for Islamic banking in Pakistan. Islamic banking is feasible but not sustainable due to the lack of public awareness about Islamic modes of financing. There is a need for diversified marketing campaigns for creating public familiarity with Islamic banking.

Ahmed<sup>31</sup> highlighted the lack of tax incentive reforms and subsidies to establish new markets as an obstacle for Islamic banking. He suggested prioritizing attention, passionate support, conjunction of religious and business school/institute to understand the real meaning of IBF and its implementation. Ahmad and Hassan<sup>32</sup> found the absence of supporting frameworks as regulatory and supervisory frameworks for the smooth functioning of Islamic financial practices. Khan and Shah<sup>33</sup> critically analyzed the regulatory and supervisory issues of Islamic banking. Akhter, Raza and Akram<sup>34</sup> reported the weak regulatory system in Pakistan. The pace to accept change as interest free banking among bankers and regulators is slow due to its recent inception. It is not necessary that conventional standards are also applicable to Islamic banking standards.<sup>35</sup> Alexakis and Tsikouras further reported that the issues of capital adequacy, protection of customer's funds, consistent and transparent procedures, Islamic rating agency and appropriate mechanism for social reporting needs attention of authorities. Hassan and Dicle<sup>36</sup> stated that the operations of Islamic banking are in-line with *Shari'ah* but it should also fulfill the

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<sup>29</sup>Irfan Butt, et.al. "Barriers to Adoption of Islamic Banking in Pakistan," *Journal of Islamic Marketing* 2, no. 3 (2011): 259-273.

<sup>30</sup>Sayyid Tahir, "Current Issues in the Practice of Islamic Banking," *Paper presented at the Course on Islamic Banking and Finance* (Iran: Tehran, 2003).

<sup>31</sup>Umer Ahmed, "Challenges Facing Islamic Banking," *Economic Review* 42, no. 2 (2011): 18-20.

<sup>32</sup>Abu Umar Faruq Ahmad and M. Kabir Hassan, "Regulatory Challenges and Opportunities: A Case of Australia," *Paper presented at the Practitioner Symposium Islamic Financial Services: What Role for Australia? Melbourne* (2009b).

<sup>33</sup>Asad Khan and Abdul Qadir Shah, "A Comparative Analysis of Regulatory and Supervisory Islamic Banking: Evidence from Pakistan, Malaysia, Bahrain, and the UK," *The Lahore Journal of Business* 4, no.1 (2015): 37-60.

<sup>34</sup>Waheed Akhter, Ali Raza Oranzab and Muhammad Akram, "Efficiency and Performance of Islamic Banking: The Case of Pakistan," *Far East Journal of Psychology and Business* 2, no. 2 (2011): 54-70.

<sup>35</sup>Christos Alexakis and Alexandros Tsikouras, "Islamic Finance: Regulatory Framework – Challenges Lying Ahead," *International Journal of Islamic and Middle Eastern Finance and Management* 2, no. 4 (2009): 90-104.

<sup>36</sup>M. Kabir Hassan and Mehmet F Dicle, "Basel II and Regulatory Framework for Islamic Banks," *Journal of Islamic Economics and Finance* 1, no.1 (2005): 17-36.





expectations of customers. They emphasized the protection of investors and customers rights in different investment funds and the issues regarding the rights of deposit insurance, current account, profit and loss sharing, capital adequacy,<sup>37</sup> *Shari'ah* knowledge and liquidity in Islamic banks. Siddiqi<sup>38</sup> recommended that Islamic banking can be Islamized at a significant level when markets will be free from monopolies and speculations, and policies which ensure the likelihood for societal welfare and equal distribution of wealth are in place. Hawary, Grais, and Iqbal<sup>39</sup> drew attention towards policy issues and policymakers' attention towards Islamic financial services internationally. Challenges with Islamic finance are a universal phenomenon that need sound reflection to imply international standards as standardization will provide a sound footing for IB to compete with conventional finance.

### 3. Methods and Procedures

A cross-sectional survey using a questionnaire was conducted to investigate bankers' perceptions with regard to regulatory challenges of Islamic banking. The questionnaire was developed by consulting previous researches and strategic plan for Islamic banking 2014-2018 developed by State Bank of Pakistan. The newly developed questionnaire was submitted to a panel of experts for review and revised accordingly. Afterwards, it was pilot tested with 15 bankers who were not part of the study sample. There were 68 statements (Cronbach's Alpha = CA= .892) distributed into nine categories, namely, Scope of regulatory authorities (12 items, CA=.572), Development issues with regulatory framework (6 items, CA=.719), Licensing and authorization (14 items, CA=.668), *Shari'ah* supervision (6 items, CA=.725), Supervisory framework (7 items, CA=.755), Institutional harmonization (5 items, CA=.726), Information disclosure (4 items, CA=.803), Market development (6 items, CA=.750), Capacity building (8 items, CA=.865). These statements were measured on 5-point Likert scale e.g. 5=strongly agree, 4=agree, 3=notsure, 2= disagree, and 1= strongly disagree (See Appendix A).

The Islamic branches of conventional banks and Islamic banks operating in Lahore were considered as study population. The data were collected from 152 bankers, selected through stratified convenient sampling process, such as managers (credit and operation), branch head, Unit heads, *Shari'ah* advisors and executives from ten banks (Table 1). The selection of Islamic bankers was purposively made because they actively participate in decisions making for the development of Islamic banking in Pakistan. The administration of the questionnaire on bankers was made

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<sup>37</sup>Christos Alexakis and Alexandros Tsikouras, "Islamic Finance" 2, no. 4 (2009): 90-104.

<sup>38</sup>Muhammad Nejatullah Siddiqi, *Issues of Islamic Banking-Selected Papers* (Leicester: The Islamic Foundation, 1983).

<sup>39</sup>El-Hawary Dahlia, Wafik Grais and Zamir Iqbal, "Regulating Islamic Financial Institutions: The Nature of the Regulated," *World Bank Policy Research Working Paper* (2004):49.



personally by the researcher herself by visiting different branches of each bank that participated in the study with permission. The Islamic bankers participated in the survey on voluntary basis. The returned questionnaires were carefully screened for accuracy and completeness of information. Both descriptive and inferential statistics were applied for data analysis using SPSS. The composite mean scores were calculated for overall regulatory challenges as well as for all nine categories. Later on, these composite variables were used to investigate the relationship between regulatory challenges and demographic variables of Islamic bankers.

**Table 1.** Number of Responses Received from Each Contributing Bank

S#	Bank Name	Bank Category	Responses
1	Al Baraka Bank	Islamic Bank	11
2	Meezan Bank	Islamic Bank	31
3	Bank Islami	Islamic Bank	36
4	Dubai Islamic Bank	Islamic Bank	8
5	MCB Bank	Islamic Bank	10
6	Bank of Khyber	Islamic Branch of conventional bank	9
7	Bank of Punjab	Islamic Branch of conventional bank	4
8	Bank Alfalah	Islamic Branch of conventional bank	7
9	Allied Bank	Islamic Branch of conventional bank	32
10	Faysal Bank	Islamic Branch of conventional bank	4

## 4. Results and Discussions

### 4.1. Demographic Profile of Survey Participants

The survey participants were asked to provide information regarding some demographic variables such as gender, qualification, professional experience, and career level. This information was required not only for establishing a demographic profile of the participants but also to group their perceptions regarding regulatory challenges for Islamic banking based on these variables. Table 2 shows the details of responses. There were 130 males and 22 females working in different banks of Lahore. A large majority of the sample (n=126, 82.9%) were post-graduates in finance followed by those who did simple graduation (n=18, 11.8%). There were only eight participants who had additional education from *Madrassa* along with post-graduation and graduation degrees.

These participants were also asked to specify their experience and the duration of their association with Islamic banks. The figures in Table 2 indicated that most of these participants (n=60, 39.5%) fall in the experience bracket 6-10 years. This was followed by those (n=56, 36.8%) who had up to five years of experience of working in Islamic banks. There were a reasonable number of participants (n=26, 17.1%) who had 10-15 years of experience. Only 10 respondents had more than 15 years of experience in Islamic banking. As far as their career level is concerned, a majority of



these participants (n=80, 52.6%) were from middle management followed by senior management (n=64, 42.1%). There were only 8 respondents who were from junior management.

**Table 2.** Demographic Summary of Participants (N=152)

S#	Demographic Variables	Frequency	%
	<b>Gender</b>		
	Male	130	85.52
	Female	22	14.47
	<b>Qualification</b>		
	Graduation	18	11.8
	Post-graduation	126	82.9
	Graduation and <i>Madrassa</i> Education	2	1.3
	Post-graduation and <i>Madrassa</i> Education	6	3.9
	<b>Experience</b>		
	1-5 years	56	36.8
	6-10 years	60	39.5
	11-15 years	26	17.1
	16-20 years	6	3.9
	Above 20 years	4	2.6
	<b>Career level</b>		
	Junior Management	8	5.3
	Middle Management	80	52.6
	Senior Management	64	42.1

#### 4.2. Participants’ Perceived Regulatory Challenges for Islamic Banking

The composite variables were computed for overall regulatory challenges as well as for all nine categories based on the responses of the survey participants. The internal consistency for overall regulatory challenges and the sub-categories were calculated using Cronbach’s Alpha (CA). Table 3 indicates the internal consistency, mean, and standard deviation for overall regulatory challenges and for all nine sub-categories. These figures indicated a reasonable and accepted level of internal consistency for all the categories as the value of Cronbach’s Alpha ranged from .572 to .865. The overall internal reliability of 68 statements was reported to be .896 which indicates about 90% reliability of the data collection instrument. In addition, these bankers tend to agree with the statements about regulatory challenges of Islamic banking for the dimensions of ‘*Shari’ah* Supervision’ (M=3.99, SD=.578), ‘Supervisory Framework’ (M=3.99, SD=.514) ‘Information Disclosure’ (M=3.88, SD=.759), ‘Institutional Harmonization’ (M=3.83, SD=.628), ‘Development Issues with Regulatory System’ (M=3.83, SD=.628), ‘Licensing and Authorization’ (M=3.69, SD=.422), ‘Scope of Regulatory Authorities’ (M=3.66, SD=.416), ‘Capacity Building’ (M=3.62, SD=.768), and ‘Market Development’ (M=3.49, SD=.688). The mean score for all 68 statements was 3.74 along with standard





deviation .345 indicating the agreement of Islamic bankers with pre-formulated list of regulatory challenges.

**Table 3.** Reliability Analysis for Regulatory Challenges

S#	Dimensions	Cronbach's alpha	Mean	Standard Deviation
1	Scope of Regulatory Authorities	.572	3.66	.416
2	Development Issues with Regulatory System	.719	3.80	.647
3	Licensing and Authorization	.668	3.69	.422
4	<i>Shari'ah</i> Supervision	.725	3.99	.578
5	Supervisory Framework	.755	3.99	.514
6	Institutional Harmonization	.726	3.83	.628
7	Information Disclosure	.803	3.88	.759
8	Market Development	.750	3.49	.688
9	Capacity Building	.865	3.62	.768
	Overall	.892	3.74	.345

#### 4.3. Gender and Regulatory Challenges

An independent samples *t*-test was performed for examining the differences in mean scores of bankers for overall regulatory challenges and their sub-categories based on the responses of male ( $n = 130$ ) and female ( $n = 22$ ) practitioners. Table 4 presents the details of results. The figures indicate no relationship between bankers' perceived regulatory challenges overall as well as for all the sub-categories except for the category of 'supervisory framework' ( $P=.006<.05$ ). It means that male bankers ( $M=4.04$ ,  $SD=.519$ ) tend to agree with the statements regarding regulatory challenges for the category of 'supervisory framework' as compared to female bankers ( $M=3.75$ ,  $SD=.413$ ) because the males scored high means than females.

**Table 4.** Gender Differences in Mean Scores of Perceived Regulatory Challenges for Islamic banking (N=152)

Dimensions	Male		Female		P-value
	Mean	SD	Mean	SD	
Scope of Regulatory Authorities (SRA)	3.66	.421	3.71	.399	.596
Development Issues with Regulatory System (DIRS)	3.79	.669	3.84	.503	.726
Licensing and Authorization (LA)	3.67	.414	3.76	.472	.352
<i>Shari'ah</i> Supervision (SS)	3.94	.591	3.77	.478	.222
Supervisory Framework (SF)	4.04	.519	3.75	.413	.006*
Institutional Harmonization (IH)	3.84	.658	3.77	.415	.636
Information Disclosure (ID)	3.90	.772	3.74	.675	.364
Market Development (MD)	3.48	.734	3.51	.302	.791
Capacity Building (CB)	3.65	.807	3.46	.646	.304
Overall	3.75	.366	3.70	.182	.564

\*  $P < 0.05$

#### 4.4. Qualification and Regulatory Challenges

The one-way ANOVA was used to determine the relationship between bankers' perceptions about regulatory challenges for Islamic banking and qualification. The results in Table 5 showed no statically significant difference in the



mean scores of regulatory challenges for the categories such as ‘Licensing and Authorization’(F= 2.60, P= .054> 0.05), ‘*Shari’ah* Supervision’(F= 1.48, P= .222> 0.05), ‘Information Disclosure’ (F= 1.83, P= .144> 0.05), ‘Market Development’ (F= 2.57, P= .057> 0.05), and ‘Capacity Building’ (F= .997, P= .396> 0.05). However, there were statistically significant mean differences in bankers’ perceptions for the overall regulatory challenges (F= 4.74, P= .003< 0.05) as well as for the sub-categories of ‘Scope of Regulatory Authorities’ (F= 3.250, P=.024 < 0.05), ‘Development Issues with Regulatory System’ (F=3.530, P=.016 < 0.05), ‘Supervisory Framework’ (F= 7.233, P= .000 < 0.05), ‘Institutional Harmonization’(F=3.771, P=.012 < 0.05) based on their qualification. In addition, Posthoc analysis using LSD indicated that the participants having higher qualification and/or *Madrasa* educations had better understanding of regulatory challenges and tended to agree with the statements for these categories as compared to those who had low level of professional education or no *Madrasa* education.

**Table 5.** Relationship of Bankers’ Perceptions about Regulatory Challenges and their Qualification

Dimensions	Levels of Education				F-Statistics	P-Value
	1	2	3	4		
Scope of Regulatory Authorities (SRA)	3.68	3.69	3.33	3.19	3.25	.024*
Development Issues with Regulatory System (DIRS)	3.54	3.86	3.67	3.17	3.53	.016*
Licensing and Authorization (LA)	3.71	3.71	3.71	3.71	2.60	.054
<i>Shari’ah</i> Supervision (SS)	3.65	3.95	3.83	4.00	1.48	.222
Supervisory Framework (SF)	3.57	4.07	4.00	3.57	7.23	.000**
Institutional Harmonization (IH)	3.62	3.90	3.80	3.13	3.77	.012*
Information Disclosure (ID)	3.64	3.94	3.25	3.50	1.83	.144
Market Development (MD)	3.28	3.55	3.00	2.94	2.57	.057
Capacity Building (CB)	3.82	3.61	3.00	3.38	.997	.396
Overall	3.63	3.78	3.42	3.33	4.74	.003**

\*P<.05, \*\*P<.01; 1= Graduation, 2= Post-graduation, 3= Graduation and *Madrasa*, 4= Post-graduation and *Madrasa*

#### 4.5. Career Levels and Regulatory Challenges

The results of One-way ANOVA (Table 6) indicated no relationships between bankers’ perceived regulatory challenges for Islamic banking and their career levels for overall and all its sub-categories except for two including ‘*Shari’ah* Supervision’(F= 4.58, P= .012< 0.05) and ‘Market Development’(F= 3.91, P= .022< 0.05). Moreover, a Post hoc analysis using LSD, due to relationship present, was conducted to identify which groups were different for these two categories. For ‘*Shari’ah* Supervision,’ the results indicated that there was no significant difference existing with respect to junior management in relation with middle and senior management (P =.874, .239 > 0.05). While in the second group of middle management there was a significant difference existing at a senior management level as p-value = .003< 0.05. In the third group, there was also a significant difference



existing between senior and middle level management with regard to their perceptions about regulatory challenges with ‘*Shari’ah* Supervision.’ Moreover, the group difference depicts that middle and senior management level have better understanding of issues with ‘*Shari’ah* Supervision’ than the junior management.

For ‘Market Development,’ the results revealed that bankers’ perceptions significantly varied for all three pairs of career levels such as ‘Junior Management,’ ‘Middle Management’ and ‘Senior Management.’ The results showed that junior management and middle level management having more interaction with dealing in market development of Islamic banking than senior management.

**Table 6.** Bankers’ Perceived Regulatory Challenges based on Career Level

Dimensions	Career Levels			F-Statistics	P-Value
	JM	MM	SM		
Scope of Regulatory Authorities (SRA)	3.69	3.72	3.59	1.74	.179
Development Issues with Regulatory System (DIRS)	3.33	3.80	3.84	2.26	.107
Licensing and Authorization (LA)	3.70	3.72	3.64	.688	.504
<i>Shari’ah</i> Supervision (SS)	4.00	4.03	3.75	4.58	.012*
Supervisory Framework (SF)	4.18	4.04	3.92	1.59	.208
Institutional Harmonization (IH)	4.15	3.81	3.82	1.09	.339
Information Disclosure (ID)	3.94	3.86	3.89	0.06	.938
Market Development (MD)	4.04	3.53	3.36	3.91	.022*
Capacity Building (CB)	4.09	3.50	3.71	2.97	.054
Overall	3.86	3.76	3.70	1.09	.338

\*P - value <.05; JM= Junior Management, MM= Middle Management, SM=Senior Management

#### 4.6. Correlation of Professional Experience with Regulatory Challenges

A Pearson correlation coefficient was utilized to test the correlation between the experience of Islamic bankers and overall regulatory challenges as well as the sub-categories while having experience as an independent variable. Table 7 indicated no correlation of Islamic bankers perceptions for overall regulatory challenges as well as for all sub-categories except the categories of ‘Development Issues with Regulatory System’ ( $P = .004 < 0.05$ ) and ‘Licensing and Authorization’ ( $P = .046 < 0.05$ ). In other words, there was a positive correlation between Islamic bankers’ experience and their perceptions with regard to ‘Development Issues with Regulatory System.’ While there was a negative relationship in bankers’ perceptions regarding issues with ‘Licensing and Authorization’ based on their professional experience.





**Table 7.** Correlation of Islamic Bankers' Professional Experience with Regulatory Challenges (N=152)

Dimensions	Pearson Correlation	P – value
Scope of Regulatory Authorities (SRA)	-.049	.552
Development Issues with Regulatory System (DIRS)	.232**	.004*
Licensing and Authorization (LA)	-.162*	.046*
<i>Shari'ah</i> Supervision (SS)	-.050	.542
Supervisory Framework (SF)	-.020	.811
Institutional Harmonization (IH)	-.099	.225
Information Disclosure (ID)	-.067	.414
Market Development (MD)	-.065	.423
Capacity Building (CB)	-.079	.335
Overall	-.078	.340

\* $P < 0.05$

#### 4.7. Nature of Bank and Regulatory Challenges

An independent samples *t*-test was conducted to test mean differences of bankers' perceived regulatory challenges with nature of the bank such as Islamic window of conventional bank and Islamic bank. Table 8 shows the results for overall regulatory challenges and its sub-categories. There was no statistically significant mean difference in bankers' perceived regulatory challenges overall as well as for all sub-categories except for the category of 'Market Development' ( $P < .05$ ). It means that bankers from Islamic branches of conventional banks ( $M=3.68$ ,  $SD=.592$ ) tend to agree with the statements regarding regulatory challenges for the category of 'Market Development' as compared to Islamic banks ( $M=3.37$ ,  $SD=.717$ ) because Islamic bankers from conventional banks scored higher means than Islamic banks.

**Table 8.** Respondents' Perceived Regulatory Challenges for Islamic Banking based the Nature of the Bank

Dimensions	Islamic		Conventional		P-value
	Mean	SD	Mean	SD	
Scope of Regulatory Authorities (SRA)	3.62	.431	3.74	.385	.088
Development Issues with Regulatory System (DIRS)	3.81	.665	3.77	.618	.677
Licensing and Authorization (LA)	3.68	.453	3.70	.366	.746
<i>Shari'ah</i> Supervision (SS)	3.85	.645	4.02	.422	.085
Supervisory Framework (SF)	3.99	.563	3.99	.423	.992
Institutional Harmonization (IH)	3.77	.684	3.93	.506	.104
Information Disclosure (ID)	3.90	.827	3.83	.629	.620
Market Development (MD)	3.37	.717	3.68	.592	.006*
Capacity Building (CB)	3.54	.839	3.75	.671	.083
Overall	3.70	.362	3.80	.307	.084

\* $P < 0.05$



## 5. Conclusion

The results provide useful insights about regulatory challenges of Islamic banking from the perspectives of IB practitioners. The findings based on scope of regulatory authorities showed that participants were satisfied with the scope of Islamic banking in Pakistan but they were not satisfied to a high extent, resulting huge variation in degree of opinions as ‘Lack of unified *Shari‘ah* ruling,’ ‘limited role of policy institution’ due to difference in practical approach,’ ‘IB governance by conventional regulatory frame work,’ and ‘confusion in institutional and regulatory structure of IB’.

While looking at the results of issues in development structure, there is a need to improve the practices in conjunction with theoretical perspectives of Islamic law to foster the developments in an effective way. The sub-category result reported that there is a lack of uniformity due to differences of opinion in schools of thought because the idea of IB has not been accepted by many. As far as issues of licensing and authorization are concerned, the results indicate a need to work on interbank money market. Ismail<sup>40</sup> highlighted that the dearth of inadequately organized Islamic interbank money market creates difficulties for banks to deal with liquidity problem. Another important concern is poor tax incentives mechanism for investors. Tax incentives are necessary to build a conducive environment for the promotion of IB.

The results reveal that paradigms for *Shari‘ah* base supervisory framework are adequate for *Shari‘ah* Supervision but there is a need to work on *Shari‘ah* auditing as it is one of the important components in *Shari‘ah* supervision. The institutional harmonization can become more adequate by establishing benchmarks for product pricing and profit calculations. KIBOR is a conventional benchmark and Islamic banks are using it, although the use of conventional benchmarks for interest free banking makes no sense. There is an important need to have Islamic benchmarks. Furthermore, the availability of branch networks is not adequate particularly in rural and also in some urban areas. It is very much needed to ease access to Islamic branches as it is a source to promote IB products and services in Pakistan.

Market development is an essential need for the promotion of Islamic banking. A huge segment of population is not fully aware of Islamic banking. The result indicates the dearth of adequate research centres, poor culture of research for product development and absence of courts to resolve disputes. It needs to be improved for the speedy progress of IB. Organizations cannot grow without ensuring the capacity building of the available human resource. The results reported that there is a lack of professional trainers and trainings for staff. The practitioners need regular trainings to

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<sup>40</sup>Abdul Ghafar Ismail, “Islamic Banks and Wealth Creation,” *ISRA Research Paper no. 9* (2010) Malaysia: Kuala Lumpur.



develop better understanding of IB globally. The respondents indicated their satisfaction about collaboration with national and international bodies.

The rise of employment opportunities is a good indicator but the quality to deal with the practical realities of IB as per Islamic law still poses a challenge for many. For reliable and timely information, the practitioners are required to stay informed of quality discourse with IB stakeholders. The results determined that literate practitioners have more ability to understand and deal with challenges. Liquidity in banks is adequate but the issue is to manage excessive liquidity. This issue can be resolved by organizing Islamic interbank money markets for the utilization of resources, along with establishing Islamic benchmarks, and tax incentives for investors and this cannot be done without the support of regulatory government bodies.

The role of *Shari'ah* advisors has high importance as they are the ones who design the structure for *Shari'ah* compliance activities and resolve issues. The results reported that the performance of regulatory structure can be monitored and evaluated through proper *Shari'ah* screening and *Shari'ah* based auditing. It is suggested that SBP with the help of *Shari'ah* experts should resolve this issue. It is imperative to invite and engage academic institutions on board by the SBP and industry for quality research, product innovation and financial engineering for the betterment of Islamic banking industry. For exceptional results, the training of the staff (*Shari'ah* professional and banking professional) is highly recommended through combined efforts of central bank and academic institutions, national and internationally. This effort will have a positive impact towards harmony and standardization of operating procedures for improved market development of IB industry in Pakistan. Serious efforts for the promotion of research culture comprising empirical evidences in favour of the IB industry is highly required to influence the masses. An effective presence of Islamic banking is recommended along with strong and logical arguments considering practical approaches to attract the potential customers for Islamic banking services.

Islamic bankers provided a pragmatic insight regarding the quality of instructions by the regulatory body for Islamic banking in Pakistan. The results are helpful for policy makers to make strategic decisions for the development and growth of IB in Pakistan. This study comprises more pragmatic insights faced by Islamic bankers and benefits both Islamic as well as other conventional banks adopting Islamic banking branches in order to increase their business opportunities. Moreover, the results of this study may assist the policy makers and regulators in policy formulation regarding Islamic banking in Pakistan. These results may also capture the interest of researchers to conduct more detailed inquiries focusing on the issues of Islamic banking in Pakistan. This study can further be replicated in other areas of Islamic financial and capital markets of the country with a large sample size to understand the commonalities and differences in the insights of practitioners working



for Islamic financial industry. A qualitative inquiry on the same topic should be conducted also to explore the different challenges faced by the practitioners of Islamic banking and finance. The data form representatives of regulatory bodies should also be conducted for more meaningful insights.

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## Appendix A

The bankers' perceptions with regard to regulatory challenges for Islamic banking were investigated on the following statements.

### Scope of Regulatory Authorities

- 1 Regulatory framework explicitly recognizes Islamic banking practices and products.
- 2 IB industry in Pakistan truly represents Islamic banking.
- 3 Islamic banking in Pakistan is governed by a conventional regulatory framework.
- 4 Regulatory framework of IB industry is compatible with global practices.
- 5 Islamic banks are facing lack of unified *Shari'ah* rulings.
- 6 IB performance and stability is ensured regularly by State Bank of Pakistan.
- 7 Regulatory framework ensures uniqueness of IB as compared to conventional banking.
- 8 The role of policy institutions is limited due to divergence in theory and practice of IB.
- 9 IB institutional structure is conflicting and confused.
- 10 IB regulatory structure creates difficulties in banking operations.
- 11 IB practitioners and regulators have freedom to give feedback to improve performance.
- 12 Regulatory policies are user-friendly for Islamic banks in Pakistan.

### Developmental Issue with Regulatory System

- 13 Differences in theory and practices of IB are a major obstacle for uniform regulations.
- 14 IB regulatory frameworks ensuring unique aspects of Islamic banking.
- 15 SBP and SECP enable policy environment for Islamic banking.
- 16 Variation in IB practices is due to difference of opinion in various schools of thoughts.
- 17 Regulatory policies for Islamic banks are transparent.
- 18 Central bank supports to achieve standardization and harmonization in IB practices

### Licensing and Authorization

- 19 Licensing requirements clearly address the issues of *Shari'ah* compliance.
- 20 Licensing of IB products and procedures is ensured before operationalization.
- 21 Effective prudential regulations are lacking in Pakistani IB industry.
- 22 Capital requirements are fulfilled and applicable to all IB.
- 23 Capital Adequacy Ratio (CAR) caters the risk specificities of Islamic banks.
- 24 Liquidity Management is adequate in IB than conventional banks.
- 25 Lack of short-term investment avenues is a challenge of liquidity management for Islamic Financial Institutions (IFI).
- 26 Lack of long-term investment avenues is a challenge of liquidity management for IFI.
- 27 IB regulators encourage interbank money market dealing.
- 28 IB regulators provide opportunities for dealing in interbank money market.
- 29 IB regulator is accountable if any Fraud or Mistake happens.
- 30 Tax incentives for investors are available in Pakistan's Islamic banking industry.
- 31 Financial services mechanism for short-term financing is adequate
- 32 Financial services mechanism for long-term financing is adequate.

### *Shari'ah* Supervision

- 33 *Shari'ah* board has the legislatives authority over *Shari'ah* issue by the regulatory bodies.
- 34 Standardization of *Shari'ah* practices in IB industry is followed strictly.
- 35 Harmonization of *Shari'ah* practices in IB industry is followed strictly.
- 36 IB regulators prefer *Shari'ah* auditing instead of highly reliance on *Shari'ah* supervision.



- 37 *Shari'ah* permissible modes and guidelines are explicit to Islamic bankers by IB regulators.
- 38 Customer protection under *Shari'ah* principles is ensured.

#### **Supervisory Framework**

- 39 IB supervisory tools (inspection manuals) are upgraded regularly.
- 40 IB supervisory framework ensures appropriate corporate governance structure.
- 41 IB industry provides customize products and solutions.
- 42 IB regulators ensure that all financial transactions are in injunction with *Shari'ah*
- 43 On-site inspection is performed adequately.
- 44 Accountability and performance of Islamic banks is ensured.
- 45 IB supervisory framework ensures auditing with relation to *Shari'ah* compliance.

#### **Institutional Harmonization**

- 46 Benchmarks for product pricing and profit calculations are adequate.
- 47 Central bank measures and monitor uniformity of Islamic banking contract and products.
- 48 Coordination and collaboration among regulators and banks of IB is adequate
- 49 IB regulations are monitored strictly.
- 50 Regulators are keenly interested for product innovation and standardization.

#### **Information Disclosure**

- 51 Clear Instructions are available to develop Islamic Financial Institution by SBP.
- 52 Quality of information (financial reports) in terms of relevance, reliability, understandability, comparability, timeliness and materiality is appropriate.
- 53 Availability of Islamic Financial Services/branch networks are adequate to urban and rural areas.
- 54 Regulators encourage the use of advanced technology.

#### **Market Development**

- 55 IB developments have witnessed development of more Islamic products.
- 56 Academic institutions are adequate for imparting IB education.
- 57 International collaborations are encouraged (Academic and industrial).
- 58 Product offering and extent of outreach is limited.
- 59 Adequate research centres' are available for innovation in IB products innovation.
- 60 Islamic banking courts are available to resolve any dispute.

#### **Capacity Building**

- 61 *Shari'ah* board/advisors having technical expertise of financial treatments other than *Shari'ah*.
- 62 Technical staff is professionally trained and qualified at IB institutions.
- 63 Training sessions are arranged regularly on IB for the understanding of *Shari'ah* advisors.
- 64 Islamic Banking Institutions (IBIs) provide adequate trainings to *Shari'ah* advisors and technical staff.
- 65 Islamic Financial Institutions do collaborative trainings.
- 66 IB regulators provide the training to trainers regularly.
- 67 Linkages and Collaboration of Islamic banks are strong with Accounting and Financial Bodies internationally. (IFSB, AAOFI, ICAP, IFIs etc).
- 68 Linkages and Collaboration of Islamic banks are strong with Accounting and Financial Bodies nationally (SBP, SECP etc).