LEGAL AND REGULATORY FRAMEWORK OF ISLAMIC BANKS IN PAKISTAN

By

AFSHAN ABBASI

LLM (CORPORATE LAW)

FACULTY OF SHARIAH & LAW
INTERNATIONAL ISLAMIC UNIVERSITY
ISLAMABAD PAKISTAN

2015

Banks (Finance law)

Banking law

LEGAL AND REGULATORY FRAMEWORK OF ISLAMIC BANKS IN PAKISTAN

By

AFSHAN ABBASI

Supervisor

Mrs. SAMINA BASHIR

Assistant Professor, Faculty of Shariah &Law

International Islamic University Islamabad Pakistan

A Thesis Submitted in Fulfillment of the

Requirement for the Degree

of

LLM (Corporate Law)

Reg. No. 371-FSL/LLMCL/F12

FACULTY OF SHARIAH & LAW
INTERNATIONAL ISLAMIC UNIVERSITY
ISLAMABAD PAKISTAN

2015

FINAL APPROVAL

It is certified that we have read the dissertation submitted by Afshan Abbasi titled "Legal and Regulatory Framework of Islamic Banks in Pakistan" as a partial fulfillment for the award of degree of LLM (Corporate Law). We have evaluated the dissertation and found it up to the requirement in its scope and quality for the award of degree.

1. **Supervisor**
   Mrs. Samina Bashir
   Assistant Professor, Faculty of Shariah
   & Law International Islamic University
   Islamabad, Pakistan.

2. **Internal Examiner**
   Mr. Zia-ur-Rehman
   Senior Lecturer, Faculty of Shariah
   & Law International Islamic University
   Islamabad, Pakistan.

3. **External Examiner**
   Mr. Pir Khizar Hayat
   Advocate High Court

DECLARATION

I, Afshan Abbasi, hereby declare that this dissertation titled "Legal and Regulatory Framework of Islamic Banks in Pakistan" is original and my own work. It has never been used before for any examination or degree in any other institution. Moreover, all sources have been used in this dissertation are completely acknowledged with references.

The work was done under supervision of Mrs. Samina Bashir (Assistant Professor) at International Islamic University, Islamabad.

Student: Afshan Abbasi

Signature: Afshan Abbasi

Date: 27-04-2015.

ABSTRACT

The title of this study is "Legal and Regulatory Framework of Islamic Banks in Pakistan". The objective of this research is two-fold. First, to explore the legal and regulatory frameworks of Islamic banks in Pakistan, Malaysia and Bahrain. And second, to draw recommendations for legal and regulatory framework of Islamic banks of Pakistan. To achieve the objectives of this research, it explains the Islamic banking in Pakistan, the difference between Islamic banking and conventional banking system, current challenges faced by Islamic banking sector, legal and regulatory frameworks of Islamic banks in Pakistan and in different developed countries. Finally, recommendations have been suggested for improvement of legal and regulatory framework of Islamic banks in Pakistan.

Dedicated To My Worthy Parents & Teachers

ACKNOWLEDGEMENT

I would praise to *Allah Subhanahu wa Ta'ala,* who gave me the opportunity to complete my degree.

First of all, I am grateful to my dissertation supervisor, Mrs. Samina Bashir, Assistant Professor at International Islamic University Islamabad, Pakistan, for her excellent guidance, knowledge, assistance, positive remarks and suggestions, despite her other professional and academic commitments.

I am very grateful to Mrs. Ghazala Ghalib Khan, Lecturer in Law at International Islamic University Islamabad and Dr. Inam Ullah Khan, Assistant Professor at International Islamic University Islamabad, who gave me consistent assistance throughout my research work.

I would also like to thanks to my parents, without support of my parents I would never have been able to complete my dissertation.

CONTENTS

Page No.

LIST OF CASES

1. Bank Kerjasama Rakyat Malaysia Berhad v Emcee Corporation Sdn
2. Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC
3. Dr. M. Aslam Khaki etc. v. Syed Muhammad Hashim etc
4. Dr. Mahmood ur- Rehman Faisal etc. v. Secretary Ministry of Law, Justice and Parliamentary Affairs, Government of Pakistan, Islamabad etc.
5. Islamic Investment Company of the Gulf (Bahamas) Ltd (IICG) v Symphony Gems N.V & Ors .
6. Messra Victor Electronics Appliances Industries vs. Habib Bank Limited and others
7. Muhammad Haq Nawaz vs. Habib Bank Limited.
8. National Bank of Pakistan Limited vs. S.G. Fiber Private Limited
9. State Bank of Pakistan v. Franklin Credit and Investment Company

LIST OF TABLES

GLOSSARY

As-Sahifah Al-Madinah:	The Charter of Madinah
Fiqh:	Knowledge of the legal ruling in the *Shariah*
Gharar:	Describes a risky, uncertainty or hazardous sale
Haram:	Forbidden
Ijarah:	Leasing contract
Mudarabah:	Profit and loss-sharing
Mudarib:	Entrepreneur
Murabahah:	the buyer purchases commodities on a deferred payment basis and subsequently sells them to a third party for a cash payment.
Musharakah:	Joint partnership
Qard hasan:	Interest-free financing
Qimar:	Speculation
Rabb-al-mal:	Capital or finance provider
Riba':	Usury/ Interest
Salam:	Future delivery of goods
Shariah:	Islamic law
Sukuk:	Islamic bonds
Sunnah:	Prophetic tradition
Takaful:	Insurance
Wadi'ah:	Safe custody
Wadi'ah-yad-Damanah:	Current Account
Wakala:	Agent
Zakat:	Sadaqa

LIST OF ABBREVIATIONS

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions
ADR	Alternate Dispute Resolution
AMLATFA	Anti-Money Laundering and Anti-Terrorism Financing Act 2001
BAFIA	Banking and Financial Institution Act, 1989
BCBS	Basel Committee on Banking Supervision
BCO	Banking Companies Ordinance, 1962
BIMB	Bank Islam Malaysia Berhad
BISB	Bahrain Islamic Bank
BMA	Bahrain Monetary Agency
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia
BSE	Bahrain Stock Exchange
CBA	Central Bank of Malaysia Act, 2009
CBB	Central Bank of Bahrain
CTFS	Commission for Transformation of Financial System
DFIA	Development Financial Institutions
ECA	Exchange Control Act, 1953
FIO	Financial Institution Ordinance
FSC	Federal *Shariat* Court
GCIBFI	General Council for Islamic Banks and Financial Institutions
IBA	Islamic Banking Act, 1983
IBB	Islamic Bank of Bahrain
IBD	Islamic Banking Department
IFA	Islamic *Fiqh* Academy
IFSB	Islamic Financial Services Board

IIFM	International Islamic Financial Market
IIFS	Institutions Offering Islamic Financial Services
IILM	International Islamic Liquidity Management Corporation
IIRA	International Islamic Rating Agency
KFH	Kuwait Finance House
MDIS	Malaysian Deposit Insurancc Scheme
MII	*Mudarabah* Interbank Investment
MSBA	Money Services Business Act, 2011
OIC	Organization of Islamic Conference
PIRI	Prudential Information and Regulatory Framework for Islamic Banks
PLS	Profit and Loss Sharing
PSA	Payment Systems Act
SAC	*Shariah* Advisory Council
SBP	State Bank of Pakistan
SCP	Supreme Court of Pakistan
SPI	Skim Perbankan Islam
SSB	*Shariah* Supervisory Board

1.2 Thesis Statement

The issues faced by Islamic banks of Pakistan due to the absence of proper and effective legal and regulatory framework need to be resolved by designing a suitable framework for Islamic banks of Pakistan

1.3 Statement of the Problem

In a developing country like Pakistan Islamic banking is a growing industry which has shown continuous success in the recent years. Presently, in Pakistan the performance of Islamic banks is remarkable in comparison to the conventional banks. The management and working of Islamic banks may improve through a proper legal[4] and regulatory[5] framework. The absence of special laws may not only put adverse effects on Islamisation process of banking but also hinders the overall performance and growth of Islamic banks.

Currently, due to the lack of a specific legal and regulatory framework, the Islamic banking industry is posed to a lot of issues. It has developed and strengthened an environment of uncertainty leading to the short term investments made by Islamic banks and financial institutions in comparison to the long term investments by the conventional banking sector.[6]

Another problem is the lack of legal and regulatory support may define the domain of Islamic banking in an uncertain manner. Due to the absence of Islamic

---

[4] The legal framework includes proper legislations, guidelines, policies, schedule of penalties, standards and specifications for banks.

[5] The regulatory framework mainly comprise for a particular subject matter, the particular body that enact the particular law, the laws and the regulating authorities that regulate the relevant laws.

[6] Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh: Edinburgh University Press Ltd, 2012), 1983.

banking laws in Pakistan, the Islamic banking practices vary from bank to bank and fail to develop the confidence of the customers in Islamic banking.

Similarly, such an ambiguity regarding laws may lead to affect the understanding and knowledge of entrepreneurs regarding Islamic banking transactions. Consequently, confusion arises regarding any specific law regulating the conduction of their transactions.[7]

Furthermore, the development of various Islamic modes of financing is constrained due to the lack of proper legal and regulatory framework for Islamic banks in Pakistan because there is no mechanism introduced by the State Bank of Pakistan for introduction of new Islamic modes of finance. On April 1985, State Bank of Pakistan has introduced 12 modes of Islamic finance.[8] Thus, it is affecting not only the Islamic banking itself but also the trust of the customers towards Islamic banking.[9]

There is no proper mechanism to deal with disputes of banker-customers and non-performing loans etc. Financial Institutions (Recovery of Finances) Ordinance, 2001 (FIO)[10] established banking courts in Pakistan. Most Islamic banking cases, if not all arise from default in installments payments. The customer's either cannot pay or would likely to delay or avoid paying the debts. In all such kind of cases, due to burden of work, low level of performance and lack of special Islamic banking laws for Islamic banking institutions in Pakistan caused delay in proceeding and customers take it as an advantage because the concept of plenty for late payment in Islamic finance is not allowed.

---

[7] http://www.shahfoundationbd.org/hannan/article10.html (accessed June 10, 2013).

[8] Muhammad Ashraf, "Development and growth of Islamic banking in Pakistan", *African Journal of Business Management* 7, no.32 (August, 2013): 3146.

[9] Ibid.

[10] http://www.sbp.org.pk/about/ordinance/r_ordinance.htm (accessed Jan. 10, 2014).

It is crucial to formulate proper and effective legal and regulatory framework for Islamic banks of Pakistan to overcome the problems faced by Islamic banking industry. Therefore, the researcher is going to examine the legal and regulatory issues faced by Islamic banks and suggest a suitable framework for Islamic banks in Pakistan.

1.4 Aims and Objectives

- To discuss the Islamic banking system in Pakistan and the differences between Islamic banking and conventional banking system.
- To explore the current legal and regulatory framework of Islamic banks and financial institutions in Pakistan. Whether any law or regulation is present with respect of Islamic banks?
- To discuss the legal and regulatory issues with regard to Islamic banks and highlight various weakness.
- To highlight the international best practices with respect to Islamic banks.
- To draw recommendations on legal and regulatory problems faced by Islamic banking industry.

1.5 Literature Review

The researchers have done a great deal of work on Islamic banking sector and volume of literature is expanding with the passage of time. The researchers continuously work on the literature as it is a new industry. This section explains the work of the researchers in the field of Islamic banking and finance.

THE REGULATORY FRAMEWORK AND THE LEGAL ASPECTS OF ISLAMIC BANKING AND FINANCE IN MALAYSIA BY MUHAMMAD ILLIYAS SAYED IBRAHIM,[11] is a comprehensive piece of literature on Islamic banking. In this paper the researcher studied the macro issues relevant to the Islamic banking and finance. The findings show that currently Islamic banks are facing some macro issues like problems related to legislature, courts, competency of judges and adequacy of present laws and mode of dispute resolution. However, the most important issue of the appropriate legal and regulatory framework of Islamic banks to work according to the principles of *Shariah* is left unaddressed.

JURISTIC DIFFERENCES IN ISLAMIC BANKING AND FINANCE BY Dr. INAM ULLAH KHAN,[12] states the difference of opinions on Islamic products offered by Islamic banking and financial institutions and its effects on cross border transactions and Islamic banking industry. The author discusses the debt based Islamic financial products such as *bay al-dayn*, *bay al-ina* etc. He also mentions that currently Islamic banking is governed by conventional legal and regulatory framework. However conventional businesses are totally separated and different from Islamic businesses. The basis of Islamic banking is prohibition of *riba* and protection of customers and provision of a system based upon our *Shariah* rulings. Therefore, the legal and regulatory framework of Islamic banks should be different and separated from conventional and investments banks. The article, no doubt, highlights the most important issues regarding Islamic banks without suggesting any mechanism to overcome such problem. The author does not give any suggestion on legal side.

[11] Mohammad Illiayas Seyed Ibrahim, "The regulatory framework and the legal aspects of Islamic banking and finance in Malaysia", in *Essential reading in Islamic finance,* ed. M.D.Bakr and Engku Rabiah (Malaysia: Centre for Research and Training Publication, 2008), 271-291.

[12] Inam Ullah Khan, "Juristic Differences in Islamic Banking and Finance", *Islamic Finance Review* 2, no.22 (May 2012): 33-35.

MEEZAN BANK'S GUIDE TO ISLAMIC BANKING BY Dr. MUHAMMAD IMAN ASHRAF USMANI,[13] discusses Islamic economic system, different Islamic contracts and also explained different Islamic modes of finance such as *musharakah, mudarabah, salam* and *ijarah* etc. However, he does not explain the current challenges faced by Islamic banks. In this book, the author explains the general principles regarding modes of Islamic finance but he does not explain the legal and regulatory side of Islamic banks.

LEGAL AND JUDICIAL PROBLEMS IN THE OPERATIONS OF ISLAMIC FINANCIAL INSTITUTIONS BY DR. ENGKU RABIAH ADAWICH ENGKU ALI,[14] discusses the legal and judicial problems in the operation of the Islamic financial institutions and the Islamic financial services globally. The author mentions some case laws in her research paper. Her study investigates the different problems faced by the countries in their legal and judicial environment; however, she does not explain the problems faced by the developing countries in their legal and regulatory framework. She discusses the problems generally faced by the countries and variations in their intensity from country to country in their legal and regulatory environment. The developing countries may face lot of problems to achieve an effective legal and regulatory environment as compared to developed countries. Because developing countries such as Pakistan, lack resources to achieve a complete and effective legal and regulatory environment.

[13] Muhammad Iman Ashraf Usmani, *Meezan Bank's Guide to Islamic Banking* (Karachi: Darul-Ishaat, 2002).
[14] Engku Rabiah Adawich Engku Ali, "Legal and Judicial Problems in the Operations of Islamic Financial Institutions", in *Nadawah al Barakah Li al Iqtisad al Islamiy* (Jeddah: Sep. 2006).

BANKING LAWS IN PAKISTAN BY MUHAMMAD MUBASHIR KHAN[15] explains the provision of Banking Companies Ordinance, 1962. However, the writer does not highlight and explain the provisions which are dealt by Islamic banks of Pakistan and which need to be amended according to the Islamic banks and are more beneficial to the Islamic banking institutions. The Banking Companies Ordinance, 1962, narrowly been defined. There are some provisions in BCO, 1962, which are amended for Islamic banking institutions. Such as section 23 was amended to allow existing banks to setup subsidiaries for Islamic banks. Section 26A was inserted which clearly describes that banking companies accept deposits on the basis of profit and loss sharing mechanism.

ISLAMIC BANKING INDUSTRY- GROWING AMID CHALLENGES BY AHMED ALI SIDDIQUE[16] explains the difference between conventional institutes and Islamic financial institutes on the basis of modes of business, product level and religion level. The writer focuses on the growth level of Islamic banks in Pakistan and explains the gradual increase of Islamic banks with the passage of time. While discussing the challenges faced by Islamic financing institutions the writer highlights some issues like lack of awareness, limited number of *Shariah* Scholars and no legal, regulatory and risk management framework. However he does not explain the future strategies that should be opted by the industry to tackle all present and future challenges.

---

[15] Mubashir khan, *Banking Laws in Pakistan* (Lahore: Uzair Publishers, 2002).

[16] Ahmed Ali Siddique, "Islamic Banking Industry Growing Aimed Challenges", *Islamic Banking and Finance Journal* 30, no.1 (2013).

STATE BANK OF PAKISTAN (SBP) STRATEGIES PLAN 2005-2010,[17] the SBP made number of plans to ensure soundness of financial sector, effective monetary management of the economic reserve management and exchange prudent, effective and sound payment system. In SBP's five year strategy plan, they only made strategies for Islamic banks to promote it as parallel to conventional banks. The SBP did not make any strategy with respect to the current issues faced by the Islamic banks of Pakistan. Currently, the most important issue is absence of proper and effective legal and regulatory framework of Islamic banks. In this report they did not focus on the most important issue. Attention should be given to the Islamic banking and financial system and there is need to make proper strategies for Islamic banks.

LEGAL ASPECTS OF ISLAMIC BANKING – MALAYSIAN EXPERIENCE BY NORHASHIMAH YASSIN,[18] specifically focuses on Malaysian Islamic banking system but can be valid for all those countries who are conducting Islamic banking, it explains that in spite of the rapid development of the Islamic banking and finance in Malaysia the legal and regulatory regime is lagging behind. Legal reforms are urgently needed in order to facilitate the smooth running and operations of Islamic banking system. However, the writer only focuses the legal framework of Islamic banks. She delves the legal issues faced by Islamic banking industry. She doesn't focus upon the regulatory issues faced by Islamic banks. The regulatory issue is as important as legal issue.

---

[17] www.sbp.org.com (accessed Sep. 08, 2013).

[18] Norhashimah Yassin, "*Legal Aspects of Islamic Banking – Malaysian Experience*", in *Islamic banking and finance: fundamentals and contemporary issues*, ed. Salman Syed Ali and Ausaf Ahmed (Jeddah: Islamic Research and Training Institute, 2007).

ISLAMIC BANKING: PAST, PRESENT AND FUTURE OUTLOOK BY DR. SHAMSHAD AKHTAR,[19] explained the status of Islamic banking in past, present and also give a future outlook. The purpose of Islamic banks was its non-interest based transaction. While discussing the current status of Islamic banking, the focus was on prudential regulation, flexibility rather than rigidity in the regulation and lastly the customer's confidence in *Shariah* compliance by the Islamic banking industry. But he did not explain accurately the current status of the banking and the problems faced by such industry. The banking industry faces number of problems like lack of legal and regulatory framework for Islamic banks in Pakistan. Currently this is the most important issue which needs special attention.

CHALLENGES FACING ISLAMIC BANKING BY MUNAWAR IQBAL, AUSAF AHMED AND TARIQULLAH KHAN,[20] explained the development of Islamic banking institutions over the last two decades and also mentioned some challenges face by Islamic banking and financial institutions. They also explained the distinguish features of Islamic banking such as profit and loss sharing mechanism and prohibition of *riba* etc. This research work is done almost 15 years ago, with the passage of time the status of banks changed and also the challenges and the problems faced by such industry also changed. Therefore, there is a need of rethinking the problems of Islamic banking and financial institutions and also introduce some mechanism to overcome the current challenges and problems.

---

[19] Shamshad Akhtar, "Islamic banking: Past, Present and Future Outlook Governor", *in SBP conference* (Karachi: State Bank of Pakistan, Sep. 2007).

[20] Munawar Iqbal, Ausaf Ahmed and Tariqullah Khan, *Challenges Facing Islamic Banking* (Jeddah: Islamic Research and Training Institution, 1998).

1.6 Limitation of Research

There are, however, some limitations to the study. The study is limited to the issues relating to legal and regulatory framework of Islamic banks in Pakistan. However, reference is made to the model of Bahrain and Malaysia for the purpose of guidance. The process of legislature is not discussed because it is beyond the ambit of this study. This study does not accommodate the details of regulatory requirements issued by the international standard setting organizations for Islamic banking and finance because it takes more space and time. Details relating to foreign Islamic banks operating in Pakistan are not discussed due to the absence of appropriate information. Taking such limitations into account best efforts are applied to bring about the most appropriate conclusion for the legal and regulatory framework of Islamic banks in Pakistan.

1.7 Significance of Study

This research paper is aimed at making a valuable contribution to the literature. Firstly, to discuss the Islamic banking and finance and describes the way through which Islamic banks can perform more efficiently and effectively. This research paper also explains the current challenges and issues faced by Islamic banks and also suggest recommendations for it. This research paper provides a literature on Islamic banking and financial institutions and practice of Islamic banks of different countries.

> I shall watch with keenness the work of your Organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice.[41]

It is clear from above discussion that struggle for the elimination of *riba* from the financial and economic system of Pakistan and the need for ordinary economic system in accord with the Islamic injunctions was publicly voiced right from the first year of the independence of Pakistan. On March 12, 1949 the first Constituent Assembly of Pakistan passed 'Objective Resolution' under the direction of Liaquat Ali Khan.[42] It clearly states that a system must be introduced through which Muslim shall be enabled to spend their lives according to clear injunctions of Islam. In 1952, the State Bank of Pakistan established 'Islamic Economic Section' for development of Islamic economics in Pakistan.[43]

The Council of Islamic Ideology (CII) was established in March 1963. The major goal of the Council was to examine the present economic and financial infrastructure of Pakistan. The Council after careful examination of economic and financial system of Pakistan declared that *riba* is unlawful. The Council strongly recommended that efforts should be made to eliminate interest from the financial and economic system of Pakistan.[44]

---

[41] Muhammad Imran, Shahzad Abdul Samad and Rass Masood, "Awareness Level of Islamic Banking in Pakistan's Two Largest Cities", *Journal of Managerial Sciences* 5, no.1 (2011):5, accessed April 05,2014, url: http://qurtuba.edu.pk/jms/default_files/JMS/5_1/JMS_January_June2010_1-20.pdf.

[42] http://historypak.com/objectives-resolution-1949/ (accessed Feb. 15, 2014).

[43] Hassan Ahmad, "Islamic Banking in Pakistan Shariah Appraisal of the Bank of Khyber Islamic Banking Division Operations" (LL.M, International Islamic University Islamabad, Pakistan, 2009), 3.

[44] Ibid.

The Constitution of Pakistan, 1973[45] also focuses on the Islamization of financial system of the country. In the Constitution of Pakistan, 1973 some special provisions were inserted by the parliament of Pakistan. In accordance with Article 38(f) Constitution of Pakistan, 1973, "The state shall eliminate *riba* as early as possible." Similarly, according to Article 227 of the Constitution of Pakistan, 1973, "All existing laws shall be brought in conformity with injunctions of Islam as laid down in the *Holy Quran* and the *Sunnah,* and no law shall be enacted which is repugnant to such injunctions."[46]

On October 23, 1977, the Council in its meeting held in Islamabad set up a Panel of Economists and Bankers to assist in the preparation of blue-print and recommend ways to remove interest from the economy as well as suggest ways for replacing the interest-based instruments. The said Panel submitted an Interim Report in November 1978, to the CII.[47] The Council recommended on the basis of this Interim Report that a beginning may be made immediately with the elimination of interest from the operations of three specialized institutions, namely, National Investment (Unit) Trust, Investment Corporation of Pakistan, and House Building Finance Corporation. The government accepted these proposals. In June 1979, Government announced its decision with effect that interest was eliminated from the operations of National Investment (Unit) Trust and House Building Finance Corporation. Amendments in HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC would be fully *Shariah* compliant

---

[45]http://punjablaws.punjab.gov.pk/public/dr/CONSTITUTION%20OF%20PAKISTAN.doc.pdf (accessed Feb. 20, 2014).

[46] Sulaman Aziz Ladhi and Rukhsana Kalim, "Strategies Direction for Developing an Islamic Banking System", *The Pakistan Development Review* 44, no.4 (winter2005):1003-1020.

[47] Ibid.

1.6 Limitation of Research

There are, however, some limitations to the study. The study is limited to the issues relating to legal and regulatory framework of Islamic banks in Pakistan. However, reference is made to the model of Bahrain and Malaysia for the purpose of guidance. The process of legislature is not discussed because it is beyond the ambit of this study. This study does not accommodate the details of regulatory requirements issued by the international standard setting organizations for Islamic banking and finance because it takes more space and time. Details relating to foreign Islamic banks operating in Pakistan are not discussed due to the absence of appropriate information. Taking such limitations into account best efforts are applied to bring about the most appropriate conclusion for the legal and regulatory framework of Islamic banks in Pakistan.

1.7 Significance of Study

This research paper is aimed at making a valuable contribution to the literature. Firstly, to discuss the Islamic banking and finance and describes the way through which Islamic banks can perform more efficiently and effectively. This research paper also explains the current challenges and issues faced by Islamic banks and also suggest recommendations for it. This research paper provides a literature on Islamic banking and financial institutions and practice of Islamic banks of different countries.

1.8 Chapterization

Chapter 1

The first chapter of the research work explains the background of the study. It contains thesis statement, problems arises due to the absence of legal and regulatory framework and also provides literature review.

Chapter 2

The second chapter of the research work is the introduction of the Islamic Banking and Finance. This chapter contains definition of Islamic banking and finance, the historical background of Islamic banking in Pakistan, different banking operations offered by Islamic banks, differences between Islamic banking system and conventional banking system and the current status of Islamic banking system in Pakistan.

Chapter 3

In the third chapter of the research, there is an attempt to explain the meaning of legal framework of Islamic banks in Pakistan, Malaysia and Bahrain and it also give details of present legislative framework of Islamic banking and finance in the countries.

Chapter 4

The fourth chapter of the research work explains the regulatory framework of Islamic banks in Pakistan, Malaysia and Bahrain. This chapter of research makes the concept of Islamic banking more clearly.

Chapter 5

The fifth chapter consists of conclusion of the research work and it also contains suggestions and recommendations for Islamic banking industry of Pakistan.

I have done my research work titled "Legal and Regulatory Framework of Islamic Banks in Pakistan." I have tried my best and spare no effort. That research is up to the mark and it is my own research. However, it is a human effort and liable to errors. Any suggestion and rectification in this regard is always welcome.

Ms. Afshan Abbasi

Islamabad, Pakistan.

29-01-2015

CHAPTER 2

ISLAMIC BANKING AND FINANCE: AN INTRODUCTION

2.1 Introduction

In recent years, the Islamic banking and finance has shown a valuable interest at globe. Due to the unique nature of Islamic banking and finance, it has received encouraging response not only from Muslim countries[21] but also some non-Muslim countries[22] have introduced Islamic banking and finance. It provides financial solution to the Muslims according to the principles laid down by the *Shariah.* The Islamic banking had shown a considerable growth potential with respect to ethical and social banking model. Presently, in the Muslim world, the retail markets and other Islamic financial institutions are choosing Islamic banking and financial system to fulfill their investment and financing needs. Islamic banks provide *Shariah* compliant products and they offer real Islamic and economic transactions and it prohibits all impermissible activities such as *riba*[23] and *gharar.*[24]

---

[21] Such as Pakistan, Malaysia, Bahrain, Turkey, Iran, Yemen, Kuwait, Qatar, Saudi Arabia, Egypt, Bangladesh, omen, UAE, Sudan, Yemen, etc.

[22] Non-Muslim countries which have introduced Islamic Banking are United Kingdom, United States, Switzerland, Sri Lanka, India, Japan, Thailand, Hong Kong, Singapore, etc.

[23] The term 'Riba' is defined by Nabil Salih as "an unlawful gain derived from the quantitative inequality of the counter value in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same efficient cause."

[24] The term Gharar is defined by Sarakhsi as "Gharar takes place where the consequences of a transaction remain unknown."

Islam is a system of entire life and it does not only deal with religious matters such as prayer, fast, zakat etc. but in fact it provides details to all worldly matters as well. It is a complete religion in all its spheres and Islam provides guidelines in all aspects of life such as a relationship between man and God, man and man and relationship between man and society with economic, moral and political values. Therefore, religion provides details of everyday life and there is no ambiguity in any worldly matter to the Muslim.[25]

The banks play a very important role in our society; the government of any country runs the economy of its country through banks. Presently, it is impossible to imagine the life without banking system and all business and financial transactions are done through banks. Presently, there are two kinds of banking system; conventional banking system and Islamic banking system. The conventional banks facilitate the people in the world but still there are some disadvantages since the world has faced major financial crises due to the conventional banks. After such major financial crises in conventional banking system, there was a need to introduce an alternative banking system which provides products according to the principles laid down by the *Shariah.*

There are five major objectives of the *Shariah* and these objectives are known as *Maqasid al-Shariah.*[26] These are preservation and protection of Din (religion), Nafs (life), Nasl (progeny), Aql (intellect) and Mal (property). The fifth *Maqasid al-Shariah* is preservation and protection of wealth. The property of every person is protected by the *Shariah* and also provides clear rules for it. These objectives of the

---

[25] Noor Ahmed Memon, "Islamic Banking: Present and Future Challenges", *Journal of Management and Social Sciences 3,* no.1 (spring 2007):2, accessed June 10, 2014, url: http://biztek.edu.pk/downloads/research/jmss_v3_n1/1-islamic%20banking.pdf.

[26] Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy International Islamic University, 2001), 11.

Shariah are considered sacred and inviolable. *Shariah* preserves and protects the property of every person from embezzlement, bribery, theft and from all unlawful mean of acquiring wealth. If any transaction, business or contract is in contradiction with these *Maqasid* al-*Shariah* are considered invalid under Islamic law. *Shariah* also prohibits the acquiring of such benefits that cause loss to other person. Therefore, Islamic banking and financial system is based on the prohibition of interest (*riba*). The purpose of Islamic banking system is prohibition of all unlawful means and also provides to the person *Shariah* compliant transactions.[27]

For the last three decades Islamic banking and finance has shown rapid growth around the globe. Islamic banking and financial system is a parallel system to the conventional banking system, not only in Muslim countries but also in non- Muslim countries where Muslims are in minority such as in United Kingdom.[28] Islamic banking and financial institutions were established in Pakistan in 1977. Currently, Islamic banking is a parallel system to conventional banking system in Pakistan. Presently, there is a presence of five full-fledged Islamic banking system and fourteen conventional banks also have Islamic banking branches.[29] The purpose of Islamic banking is to provide an interest free system to the people and invest his money according to permissible Islamic modes of finance. In a short period of time, Islamic banking and finance has made valuable achievements but still there are many challenges posed to the Islamic banking institutions such as absence of standardization

---

[27] Hussan Ahmed, "Islamic Banking in Pakistan Shariah Appraisal of the Bank of Khyber Islamic Banking Division Operations" (LL.M Thesis, International Islamic University Islamabad, Pakistan, 2009), 3.

[28] The British Government established Al Rayan Bank in2004. Formally this bank was known as Islamic Bank of Britain. It provides Shariah complaint products to the Muslims of British. Both Muslims and non-Muslims can take the services of Al Rayan Bank. It has branches in Birmingham, London and Manchester.

[29] Quarterly Compendium: Statistics of the Banking System [June 2013], url: http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20list%20of%20islamic%20banks (accessed Jan. 31, 2014).

and harmonization of laws, lack of awareness and Islamic banking practice vary from bank to bank. Therefore, there is a need of a complete, proper and effective legal and regulatory framework for Islamic banks. Presently in Pakistan Islamic banks are governed by conventional banking legal and regulatory framework. Conventional financial activities are different from Islamic financial activities. The basis of Islamic finance is prohibition of *riba* while conventional financial activities are based on interest. Therefore, the Islamic banking industry needs a proper and effective legal and regulatory framework that's must be based on *Shariah* compliant principles.

2.2 Definition of Islamic Banking and Finance

The Islamic banking has been defined as a system which is governed by the principles laid down by the *Shariah.* The basic purpose of Islamic banking is providing Interest free banking operations and instruments. The purpose of Islamic banking is the achievement of Islamic economic system and economic prosperity.[30]

> Islamic bank is an institution that invests financial resources in acceptable Islamic businesses and attempt to achieve predetermined Islamically acceptable financial and social objectives. Both investment and mobilization of funds should be conducted according to the principles laid down by the Islamic *Shariah.*[31]

The Organization of Islamic Conference (OIC) defines Islamic banking as: "it is a financial institution whose statutes, rules and procedures expressly state its commitment to the principle of Islamic *Shariah* and to the banning of the receipts and payment of interest on any of its operations."[32]

---

[30] http://www.sbp.org.pk/departments/ibd/FAQs.pdf 9 (accessed Feb.04, 2014).

[31] http://www.albaraka.com/default.asp?action=article&id=46 (accessed Feb. 04, 2014).

[32] Nasiruddin Ahmed, "Islamic Banking and its Modes of Investments", *Australian Journal of Anthology*, 307.

The reason to form Islamic banking system is to follow the divine instructions in all transactions whether it is worldly or religious. Therefore, Islamic banking should not only be limited to the principle of prohibition of *riba* and sharing of profit and loss but there should also be elimination of *qimar* (speculation) and *gharar* (uncertainty or risk).

Interest based transactions are completely forbidden in Islam and it is mentioned explicitly in the various verses of the *Holy Quran*.[33] There are about 20 verses of the *Holy Quran* which deals with *riba* and taxation issues. For example:

> And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah; but that which you give in *Zakat* (sadaqa - charity etc.) seeking Allah's Countenance, then those, they shall have manifold increase.[34] That they took *riba* (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment.[35]

However, the prohibition of interest in the *Quran* does not mean that there is no return to the depositor. Islam also recognizes profit on capital but in accordance with Islamic law, a person is entitled to profit only when he agrees to bear the loss on such capital.[36] Wage or remuneration is therefore received by the manager/labor and profit is received by the depositor.

---

[33] Quran is a speech of Allah in Arabic and it was revealed on the last Prophet Hazrat Muhammad (P.B.U.H). It is compiled and collected under the protection of Allah. It is a last Holy book which was revealed upon our last Prophet (P.B.U.H).

[34] Sura Ar-Rum (30:39).

[35] Sura An-Nisa (4:161).

[36] Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy International Islamic University, 2001), 13.

2.3 Historical Development of Islamic Banking and Finance in Pakistan

The first Islamic bank Mit Ghamr Savings Bank was established by Mr. Ahmad Ali Najjar in 1960s, in Egyptian town.[37] This experiment became very popular, after that many branches of Mit Ghamr Savings Bank were introduced in Egypt. Nevertheless, in 1971, the project of Mit Ghamr was revived by another bank which was known as Naseer Social Bank.[38] The bank had received a very encouraging response. Later on there were many Islamic banks established in other Muslim countries. The Islamic Development Bank (IDB) is an international Islamic financial institution, also established for development and growth of Islamic banking and financial institutions.[39]

Since 1947, the people of Pakistan were eager for an Islamic state which is truly based on the principles and injunctions of Islam. They also demanded the elimination of *riba* from the financial and economic system of the country. On 1st July, 1948 Pakistan established the State Bank of Pakistan which is the Central Bank and also the regulator of financial sector. The first Governor of the SBP Mr. Zahid Hussain,[40] in 1948, stated that "we shall convert our present financial system according to the teachings of Islam." Quaid-e-Azam Muhammad Ali Jinnah, the founder of Pakistan gave his speech on the inauguration of the State Bank of Pakistan and said:

---

[37] Abdelkader Chachi, "Origin and Development of Commercial and Islamic Banking Operations", *Islamic Economics Research Centre* 18, no, 2 (2005), 7.

[38] Abu Umar Faruq Ahmad, *Developments in Islamic Banking Practice: The Experience of Bangladesh* (Florida: Universal Publishers Boca Raton, 2010), 99.

[39] Zafar Ahmas Khan, *Islamic Banking and its Operations* (London: Institute of Islamic Banking and Insurance), 1.

[40] http://www.sbp.org.pk/about/governors/past.htm (accessed Feb. 10, 2014).

> I shall watch with keenness the work of your Organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice.[41]

It is clear from above discussion that struggle for the elimination of *riba* from the financial and economic system of Pakistan and the need for ordinary economic system in accord with the Islamic injunctions was publicly voiced right from the first year of the independence of Pakistan. On March 12, 1949 the first Constituent Assembly of Pakistan passed 'Objective Resolution' under the direction of Liaquat Ali Khan.[42] It clearly states that a system must be introduced through which Muslim shall be enabled to spend their lives according to clear injunctions of Islam. In 1952, the State Bank of Pakistan established 'Islamic Economic Section' for development of Islamic economics in Pakistan.[43]

The Council of Islamic Ideology (CII) was established in March 1963. The major goal of the Council was to examine the present economic and financial infrastructure of Pakistan. The Council after careful examination of economic and financial system of Pakistan declared that *riba* is unlawful. The Council strongly recommended that efforts should be made to eliminate interest from the financial and economic system of Pakistan.[44]

---

[41] Muhammad Imran, Shahzad Abdul Samad and Rass Masood, "Awareness Level of Islamic Banking in Pakistan's Two Largest Cities", *Journal of Managerial Sciences* 5, no.1 (2011):5, accessed April 05,2014, url: http://qurtuba.edu.pk/jms/default_files/JMS/5_1/JMS_January_June2010_1-20.pdf.

[42] http://historypak.com/objectives-resolution-1949/ (accessed Feb. 15, 2014).

[43] Hassan Ahmad, "Islamic Banking in Pakistan Shariah Appraisal of the Bank of Khyber Islamic Banking Division Operations" (LL.M, International Islamic University Islamabad, Pakistan, 2009), 3.

[44] Ibid.

The Constitution of Pakistan, 1973[45] also focuses on the Islamization of financial system of the country. In the Constitution of Pakistan. 1973 some special provisions were inserted by the parliament of Pakistan. In accordance with Article 38(f) Constitution of Pakistan, 1973, "The state shall eliminate *riba* as early as possible." Similarly, according to Article 227 of the Constitution of Pakistan, 1973, "All existing laws shall be brought in conformity with injunctions of Islam as laid down in the *Holy Quran* and the *Sunnah,* and no law shall be enacted which is repugnant to such injunctions."[46]

On October 23, 1977, the Council in its meeting held in Islamabad set up a Panel of Economists and Bankers to assist in the preparation of blue-print and recommend ways to remove interest from the economy as well as suggest ways for replacing the interest-based instruments. The said Panel submitted an Interim Report in November 1978, to the CII.[47] The Council recommended on the basis of this Interim Report that a beginning may be made immediately with the elimination of interest from the operations of three specialized institutions, namely, National Investment (Unit) Trust, Investment Corporation of Pakistan, and House Building Finance Corporation. The government accepted these proposals. In June 1979, Government announced its decision with effect that interest was eliminated from the operations of National Investment (Unit) Trust and House Building Finance Corporation. Amendments in HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC would be fully *Shariah* compliant

[45] http://punjablaws.punjab.gov.pk/public/dr/CONSTITUTION%20OF%20PAKISTAN.doc.pdf (accessed Feb. 20, 2014).

[46] Sulaman Aziz Ladhi and Rukhsana Kalim, "Strategies Direction for Developing an Islamic Banking System", *The Pakistan Development Review* 44, no.4 (winter2005):1003-1020.

[47] Ibid.

institution,[48] which will play an effective role both in promotion of Islamic financing method but also in the development of the important housing sector. While in case of Investment Corporation of Pakistan, interest was eliminated from its Mutual Funds operations only. It's others operations were made interest free subsequently. A scheme of interest free loans to small farmers was also launched from 1st July, 1979. Meanwhile, necessary amendments were made in the legal framework of financial and corporate system of the country to remove the legal hindrances. A new financial instrument called Participation Term Certificates (PTC)[49] was introduced in June 1980,[50] to replace the interest-based debentures. The PTC is transferable corporate instruments based on the criteria of profit and loss sharing.[51]

New laws, namely, the Mudarabah Companies and Mudarabah Ordinance, 1980, along with the Mudarabah Companies and Mudarabah Rules, 1981 was promulgated to introduce *mudarabah* as a two-tier fund structure for understanding *Shariah* compliant businesses. The Banking and Financial Service Ordinance, 1984

---

[48] Prior to 1977 the House Building Finance Corporation used to run its business on interest based means and methods. The House Building Finance Corporation started providing Islamic house financing on the basis of Diminishing Musharakah from 1st July, 1979. The first model of Islamic house financing was introduced and notified by the HBFCL was on Profit and Loss Sharing (PLS), the HBFCL introduced a new product named Ghar Aasān on the basis of Diminishing Musharakah during 2002-08 HBFCL introduced a product for financing contractors/builders in 2003 with the name Shandar Ghar on the basis of murabahah to the purchase orderer. The House building Finance Corporation introduced a comprehensive scheme after Ghar Aasān late in 2007. This facility is based on diminishing Musharakah and is only being practiced for providing house financing in House Building Finance Corporation. Other schemes like Ghar Aasan, Shandar Ghar etc. have been closed by HBFCL.

[49] Participation Term Certificates (PTCs) are transferable corporate instruments with a maximum maturity of ten years and allow temporary partnership or Musharakah. It is a financial arrangement between a financial institutions and entity on the basis of profit and loss sharing mechanism over the maturity period of certificate. It was introduced as alternative to debenture (which is interest based) for raising medium term financial resources.

[50] Zubair Iqbal, Abbas Mirakho, Islamic Banking (Washington, D.C: External Relations Department Unit IMF, 1987), 13.
url:https://books.google.com.pk/books?id=33sR2RVKRZ8C&pg=PA16&lpg=PA16&dq=participation+term+certificate+introduction+in+pakistan&source=bl&ots=Nt71hfrt&sig=aEcT7X17j6D3X8MmhQQ6_VFSfnw&hl=en&sa=X&ei=tjUiVYmNFdfjaqTbglgP&redir esc=y#v=onepage&q=participation%20term%20certificate%20introduction%20in%20pakistan&f=false

[51] Ibid.

amended various laws and for recovery of finance, introduced Banking Tribunal Ordinance, 1984. [52]

The SBP launched a program of complete shifting over of the entire interest based banking system to a non-interest based system. On June 20, 1984, the SBP issued BCD Circular 13, which made the following provisions:[53]

a) As from July 1, 1985,[54] no banking in Pakistan would accept any interest bearing deposits and all deposits would be on the basis of participation in profit and loss of the banking company except deposits received on current account on which on interest or profit would be given by the banking company.[55]

b) As from April 1985, all finances provided by a banking company to any entity including individuals would be only in the 12 modes specified in the Circular.[56]

Foreign banks were also not allowed to accept any interest-bearing deposits. All existing deposits in a bank were treated to be on the basis of profit and loss sharing. However, the above-mentioned instructions of the SBP were not made applicable to foreign currency deposits in Pakistan and lending of foreign loans, which continued to be governed by the terms of the loan. A new law, called the Banking

---

[52] Ibid.

[53] Zubair Iqbal, Abbas Mirakho, Islamic Banking (Washington, D.C: External Relations Department Unit IMF, 1987), 15.
url:https://books.google.com.pk/books?id=33sR2RVKRZ8C&pg=PA16&lpg=PA16&dq=participation+term+certificate+introduction+in+pakistan&source=bl&ots=Nt71hfrt&sig=aEcT7X17j6D3X8MmhQQ6_VFSfnw&hl=en&sa=X&ei=tjUiVYmNFdfjaqTbgIgP&redir_esc=y#v=onepage&q=participation%20term%20certificate%20introduction%20in%20pakistan&f=false

[54] Abdul Karim Aldohn, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at United Kingdom and Malaysia (*New York: Routledge, 2011), 17.

[55] Muhammad Ashraf, "Development and growth of Islamic banking in Pakistan", *African Journal of Business Management* 7, no.32 (August, 2013): 3146.

[56] Ibid.

Tribunal Ordinance, 1984, was promulgated.[57] The main purpose of this law was to protect the banks against undue delays and defaults in repayment by parties obtaining finance from them. According to the provisions of the said Ordinance, the Tribunal are required to dispose of all cases within 90 days of the filling of the complaint. The High Court was made appellate authority to hear appeal against the decision of Tribunal.

The State Bank of Pakistan termed this "Shift over to Islamic Modes of Financing." However, unfortunately in practice most of these modes contain provisions, which either violate the injunctions of *Shariah* or can at best be termed as second line fixed return techniques. The two important areas namely, the foreign transactions and the government's own fiscal and monetary operations were excluded from the process of Islamization by the then Government. Thus, interest would continue to be paid on all amounts borrowed from foreign countries.

The FSC announced its historical judgment on December 14, 1991. In the case titled *Dr. Mahmood ur- Rehman Faisal etc. v. Secretary Ministry of Law, Justice and Parliamentary Affairs, Government of Pakistan, Islamabad etc.* (1992),[58] the Court declared that the provisions of interest in a number of fiscal laws come under the definition of *riba* and thus these provisions were repugnant to the *Shariah*. The Court also declared that the mark-up system as in vogue in Pakistan under the banner of Islamic system of banking is against the injunctions of Islam as it is nothing, but interest. The court further held, that interest, whether simple or compound for productive or consumptive purposes is covered within the definition of *riba*. The Court declared that government operations require equal amount of cleansing and that

[57] Menara Tun Razak and Jalan Raja Lautt, *Islamic Financial System Principles and Operations* (Kuala Lumpur: International Shariah Research Academy for Islamic Finance, 2012), 658.

[58] Pakistan Law Decisions, 1992 Federal Shariat Court 1.

no exception can be given to protect the transactions with the foreigners or in foreign currency. The Court fixed June 30, 1992, as the day when this judgment would come into effect, after which these legal provisions would be null and void.[59]

The Islamization process of the financial system took an historic step forward with the above ruling of the FSC. This ruling put pressure on the government to take appropriate action by that date to amend or substitute these laws in the light of *Shariah.* However, the government, which defended the concerned laws during the hearings, moved an appeal in the Shariat Appellate Bench (SAB) of the Supreme Court. The SAB automatically stayed the operations of the judgment. Meanwhile, in 1991, the Parliament enacted the Enforcement of Shariat Act, 1991. According to Section 8 of the said Act, the government constituted a Commission headed by the Governor of the State Bank of Pakistan, and comprising members of Parliament, *Ulema* expert on finance, banking and law and retired government functionaries. The Commission was reconstituted in 1997. The combined works of these Commissions was submitted to the government in August, 1997. The work of the Commission proposed a comprehensive strategy for the elimination of interest from the economy.

The SAB of the Supreme Court delivered its judgment on December 23, 1999 rejecting the appeals.[60] The SAB also directed its judgment that laws involving interest would cease to have effect finally by June 30, 2001. The Appellate Court held that all prevailing forms of interest fall within the definition of *riba,* which is strictly prohibited by the Holy Quran. The SAB declared that the present interest based financial system of Pakistan is against the injunctions of Islam and order to bring it in

[59] Ibid.
[60] Aurangzeb Mehmood, "Islamisation of Economy in Pakistan: Past, Present and Future", Islamic Studies 41, n0.4 (2002), 688.

conformity with *Shariah.* It has to be subjected to radical charges. It also directed the government to set up, within specified time frame, a commission for transformation of the financial system.[61]

The State Bank of Pakistan (SBP) highlights some permissible Islamic modes of finance that should be adopted by Islamic banks. The Islamic modes of finance are *mudarabah, musharakah, istisna, ijara, salam* etc.[62] In June, 2000 State Bank of Pakistan (SBP) constituted a Commission for Transformation of Financial System (CTFS). The purpose of such commission was to prepare a draft that could help to bring all transactions according to the principles of *Shariah.* The commission submitted two interim reports in October, 2000 and in May, 2001. On August, 2001 the commission finally submitted its report. In accordance with CTFS there was a need of *Shariah* compliant financial environment, launching a massive education and training program for clients and banks and creating legal Islamic infrastructure. Meezan Bank Limited emerged as the first full fledge Islamic bank in Pakistan in 2002. Today in Pakistan, there are 5 full-fledge Islamic banks such as Meezan Bank Ltd, Dubai Islamic Bank Ltd, BankIslami Pakistan Ltd, Burj Bank Ltd and AlBaraka Bank Ltd. SBP allows the conventional banks to establish Islamic banking branches[63] and currently 14 Islamic branches of conventional banks are working.

The historical review of Islamic banking and finance in Pakistan shows that there is a continuous growth and development in Islamic banking sector during the

[61] Dr. M. Aslam Khaki etc. v. Syed Muhammad Hashim etc (2000), Pakistan Law Decisions, 2000 SC 225, url: http://pakistanconstitutionlaw.com/p-l-d-2000-sc-225/.

[62] Sulaman Aziz Ladhi and Rukhsana Kalim, "Strategies Direction for Developing an Islamic Banking System", *The Pakistan Development Review* 44, no.4 (winter2005):1003-1020.

[63] Quarterly Compendium: Statistics of the Banking System [June 2013], accessed Jan. 31, 2014,http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20li

past three decades but still some space is left such as absence of proper and effective legal and regulatory framework. Therefore, there is a need of proper legislation and regulation of Islamic banking sector.

2.4. Islamic Banking Operations

Business organization is primarily originated for the sake of profit by performing lawful activities. Banks are also one of the business organizations that provide a set of products and services to generate profits. Islamic bank works as a trading concern and financial intermediary to perform interest free activities purely according to the principles of *Shariah.* It is a welfare organization that promotes business and trade activities by pooling the financial resources for the sake of profit and loss for mutual benefit. It is found that Islamic bank performs activities in the right direction towards human development.[64] Islamic banks perform fund based activities. Fund based activities are called primary functions of Islamic bank i.e. acceptance of deposits from savers on profit & loss basis and lend money to deficient individuals or business entities on profit and loss basis. Islamic bank accepts deposits against savings and current accounts. It accepts deposits against investment accounts to generate income. Islamic bank invests this amount into different profitable ventures as an agent and shares the consequences.[65]

The banking operations for all Islamic banks are the same. The banks conduct their operations through current accounts, investment accounts and saving accounts. The nature of all types of contracts is different from each other. The major categories of accounts are as following:

---

[64] http://prr.hec.gov.pk/Chapters/913S-2.pdf (accessed April 03, 2015).
[65] Ibid, 34.

2.4.1 Deposits Account

Deposits are important source for Islamic banks. The Islamic banks use deposits to increase its capacity for financial operations. There are following three kinds of deposits accounts i.e., saving accounts, current accounts and investment accounts.[66]

i. Current Account

Current account in Islamic banks is based on the principle of *qard hasan* (interest free loan) and *wadiah-yad-Damanah* (safekeeping with guarantee). The purpose of current account, whether it is *wadiah* account or *qard hasan* account, is to provide a safe custody to the depositor's assets. The depositor deposits his assets in the safe custody of another person who is not the owner of assets.[67]

Al wadiah (safekeeping with guarantee) is basically an agreement between two parties in which one party deposits its assets in the safe custody of another person. In such type of agreement the bank uses the deposits at its own risk. The customer neither shares the loss nor the profit that generated by the bank from his deposits. Therefore, the bank shall bear all the losses and is entitled to all profit from such investments. Another important feature of such type of contract is that the depositor can withdraw his deposits at any time. The profits earned by the bank from use of such deposits belong to the bank and the depositor entitles for his principle amount

[66] Inam Ullah Khan, "Legal and Regulatory Framework of Islamic Banking", in *Islamic Transactions and Finance: Principles and Developments*, ed. Mohammad Hashim Kamali and Sheila Ainon Youuof (Kuala Lumpur: International Institute of Advanced Islamic Studies, 2013), 180.

[67] Rehman Naeem, "Attitude of Muslims towards Islamic Banking and Finance in the North West of England: A Socio-Economic perspective" (Durham Thesis, Durham University, 2012), 94.

only.[68] The legality of Wadiah is also mentioned in the following verse of Holy Quran:[69]

Indeed, Allah commands you to render trust to whom they are due and when you judge between people, to judge with justice.

Current accounts are also based on the principle of *qard hasan* (benevolent loan). The meaning of *qard* is to give something to another person having value; subject to the condition that similar or same amount of the thing would be paid back on the demand of the person. Therefore, Islamic banks operate *qard hasan* current accounts. In *qard hasan* current accounts there are two parties i.e. lender and the bank. The lender is not entitled to any profit because bank uses such deposits at its own risk. The bank is entitled to all the profit as well as bears all the loss because if such deposit is taken by the lender (depositor) it amounts to *riba* which is purely against the principles of *Shariah*. Such type of accounts facilitates the depositor to withdraw his amount at any time. The *qard hasan* current account is accepted in Bahrain Islamic Bank (BISB), Kuwait Finance House (KFH) and in Middle East. While the current accounts in Malaysia is based on *wadiah* accounts.[70]

The difference between *wadiah* current account and *qard hasan* current account is that in *wadiah* account the deposits are used by the bank and deposits are considered as guarantee in the safe custody of bank. While in *qard hasan* current account, the deposits are considered as *qard hasan* and used by bank at its own risk. But the underline purpose of both types of accounts is the same. The purpose of both

[68] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, in *Islamic Transactions and Finance: Principles and Developments*, ed. Mohammad Hashim Kamali and Sheila Ainon Youuof (Kuala Lumpur: International Institute of Advanced Islamic Studies, 2013), 180.

[69] Al Quran. Al-Nisa, 4:58

[70] http://www.financialislam.com/investment-and-transactions.html (accessed Jan 21, 2014).

types of accounts is to provide a safe custody to the depositor's assets. The principle of both the accounts is same; the depositor is not entitled to any profit as well as not liable for any loss, while, the banks are entitled to all such profits and liable for all losses. The depositor is entitled to his principle amount only and nothing more than that because it amounts to *riba.*[71]

ii. Saving Accounts

The saving accounts provide three models; *wadiah, mudarabah* and *qard hasan*. In *wadiah* mechanism the bank guarantees the customer to repay the principle amount at any time. After taking permission from the depositor the bank can use the fund and generate profits from such funds. All profits belong to the bank through the use of funds of the customer. In *wadiah* mechanism Islamic banks act as a trustee of the funds and give guarantee of the return of the said amount on demand. This model is used by Malaysian banks. [72]

The second model offered by banks in saving account is *mudarabah*. In *mudarabah* saving accounts, deposits or withdrawal of money can take place at any time and rate of profit is declared by the bank. In such type of arrangement the bank acts as a *mudarib* for customer and depositor can deposit and withdraw his amount at any time.[73] This model is used by Kuwait Finance House and Bahrain Islamic Bank.

The third model is *qard hasan*. This mechanism is similar to a current account deposits. The deposits are considered as *qard* or loan to the bank by the depositor. The

---

[71] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, in *Islamic Transactions and Finance. Principles and Developments*, ed. Mohammad Hashim Kamali and Sheila Ainon Youuof (Kuala Lumpur: International Institute of Advanced Islamic Studies, 2013), 180.

[72] Ibid.

[73] Ibid.

qard hasan account is similar to *wadiah* account. Basically the customers are not entitled to any profit but bank provides a gifts and benefits to its depositors.

In Malaysia saving accounts are based on the principle of guaranteed custody or *al-wadiah yad dhamanah.* While in Kuwait, Pakistan and United Arab Emirates saving accounts are governed by the principle of *mudarabah.*

iii Investment Account

The investment account can also be said *mudarabah* accounts. The investment accounts are based on *mudarabah* contract. *Mudarabah* contract is defined by Ali al-Khafif as "contract for sharing the profit of a business in which one party contributes with capital and the other with his labour."[74]

The rule is also emphasized by the *Holy Quran* in the following verse: *"And others who journey through the earth seeking the bounty."*[75]

In *mudarabah* contract, there are two parties, *mudarib* and *rabb-al-mal.* The customer acts as a *rabb-al-mal* while bank acts as a *mudarib.* The profit is distributed according to the agreed ratio and typically it is 70% and 30% between the bank and the customer respectively. The parties of *mudarabah* contract may change the ratio of profit from time to time. In such mechanism customer bears all the loss whereas bank is not responsible for the loss. Therefore, there is a need that the bank needs to be more vigilant due to the fact that the loss is borne by the customer, hence customer must be provided with the required protection against the potential insolvency of the bank. Malaysia has introduced the Malaysian Deposit Insurance Scheme (MDIS), the

---

[74] Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy International Islamic University, 2001), 276.

[75] Al-Quran 73:20.

purpose of which was to promote above mentioned financial instability and protection to the customers.[76]

While Islamic banks provide all sort of current accounts, saving accounts and investment accounts, loss is transferred to the customer even if it is caused by bank's failure. Therefore, there is a need for a proper legislation in case of losses on current accounts and prudential regulation framework in case of losses on investment accounts by Islamic banks in order to provide protection against such kind of losses.

2.4.2 Characteristics of Islamic Deposit Accounts[77]

a) In Malaysia saving accounts are based on the principle of guaranteed custody or *al-wadiah yad dhamanah.* While, in Pakistan saving accounts are governed by the principle of *mudarabah.* In investment accounts facility *mudarabah* principle is used by all countries.

b) The difference between current account and saving account is that in current account the customer is capital guaranteed, while, in saving account the bank provides a share in the profit earned from the use of the deposits of the customer. This share is inconsistent as it is not made a part of the main agreement. However, it is not against the principles of *Shariah* as this is not included in the agreement.

c) The investment account is based on the principle of *mudarabah,* in which the customer authorises the bank for the investment of the funds. The profit is distributed between the bank and the customer on a pre-agreed

---

[76] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking,* in *Islamic Transactions and Finance: Principles and Developments*, ed. Mohammad Hashim Kamali and Sheila Ainon Youuof (Kuala Lumpur: International Institute of Advanced Islamic Studies, 2013), 180.

[77] Sudin Haron, "A Comparative Study of Islamic Banking Practices", *J.KAU Islamic Econ* 10 (1418 A.H / 1998 A.D), 27-28.

ratio. But loss is borne by the customer. While, the *qard hasan* account is considered as a benevolent loan from the depositor to the bank.

d) The current account is non-profit account because the customer not bear any risk of loss, he is capital guaranteed. The basis of Islamic contract is that a person is entitled of profit only when he bears the risk of loss.[78] That's why the current account holders are not entitled for profit.

2.5 Difference between Islamic Banking and Conventional Banking System

Islamic finance has been defined by Professor Khurshid Ahmed[79] as:

> Islamic economics is a systematic attempt to study the economic problems and man behavior in relation to form an Islamic perspective. It is also an effort to develop a framework for theoretical understanding, as well as to design appropriate institutions and policies, pertaining to the process of production, distribution and consumption, that will enable optimal satisfaction of human needs, enabling man to serve higher ideals in life.[80]

There are various similarities between Islamic banks and conventional banks. The conventional banks and Islamic banks are financial intermediaries and they are administrator of economic system. The purpose of all kinds of banks is to remove imperfections from financial market. The imperfections include imperfect information, customer's exploitation, imperfect divisibility of financial claims, financial scams and transactions cost of acquisition and search. Both banks perform similar functions such as to help the people to transfer the funds from depositors,

---

[78] Muhammad Tahir Usmani, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy Islamabad,2001), 13.

[79] http://www.ips.org.pk/aboutips/team/1200-complete-profile-prof-khurshid-ahmad.pdf (accessed March 10, 2014).

[80] Hussain Ahmed, "Islamic Banking in Pakistan *Shariah* Appraisal of the Bank of Khyber Islamic Banking Division Operations" (International Islamic University Islamabad, Pakistan, 2009), 15.

savers or investors to depositor or borrowers, financing, issuing letter of credit, letter of guarantee and many other activities.

On the other hand, there are a lot of differences between conventional banks and Islamic banks. The major differences are as follows;

2.5.1 The Difference at Conceptual level

The Islamic banking and finance prohibits paying and charging of *riba* (interest) and it is based on real transactions.[81] There is prohibition of *gharar* (uncertainty), *qimar* (gambling), *khilabah* (fraud and cheating), and *ghishsh* (deception). In Islamic banking and finance all transactions are permissible unless and until they are contradiction with text of the *Holy Quran* and *Sunnah*.[82]

The business of conventional banks is based on interest in all transactions; borrowing and lending of money are conducted through interest. Conventional banking system offers sale of debts, short term sale and speculative transactions. Conventional banks permit finances to all type of industries.[83]

Islamic banking is a new regime in current banking system. The purpose of Islamic banks is the achievement of an interest free and Islamic economic system. In Islamic banking operations, *riba* is prohibited and their operations are based on *mudarabah, musharaka, salam, istisna* etc. They make their investments according to *Shariah* compliant principles and avoid investments in unethical projects like investments in alcohol, gambling business. Generally, Islamic banks earn money

---

[81] Ahmed Ali Siddique, "Islamic Banking Industry Growing Aimed Challenges", *Journal of Islamic Banking and Finance* 30, no.1 (2013):2 accessed May 26, 2014, url: http://www.meezanbank.com/docs/IBIG.pdf.

[82] Muhammad Tahir Usmani, *Islamic Law of Contract and Business Transactions* (Islamabad: Shariah Academy Islamabad,2001), 16.

[83] Ibid.

through trading, leasing, profit and loss sharing mechanism and using other legitimate means to earn money. While Islamic banks must comply with the *Shariah* principles and prohibit unethical practices, the conventional banking system is purely based on interest based financial system and is based on financing profitable projects.[84] The principles of conventional banks are based on man-made laws. Whereas interest based transactions are completely forbidden in *Shariah* and as mentioned in number of *Quranic* verses:

"O you who have believed, do not consume usury, doubled and multiplied, but fear Allah; that you may be successful."[85]

2.5.2 Financing and Investments in Islamic Banks

Conventional banks and Islamic banks provide credit facility to its customers but nature of financial agreement is different in both institutions. Conventional banks provide credit facility and charge fixed amount of interest on principle amount whereas, Islamic banking system does not charge interest on loan, they take profit on investments and such profit is distributed among the customer and the bank. Conventional banks offer three kinds of loans; short-term loans, long-term loan and overdrafts. Islamic banks issued *qard hasan* (interest free loans) and they cannot charge interest because it is against the principles of *Shariah.*[86]

In Islamic banking system the bank shares profit as well as loss with the customer through different mechanism such as in *mudarabah* and *musharakah.* Sometime banks act as a partner of the customer and sometime they act like an agent

---

[84]http://www.bankislam.com.my/en/documents/shariah/broaddistinctionbetweenislamicconventional.pdf (accessed Jan. 26, 2014).

[85] Al-Quran 3:130

[86]Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking", *International Journal of Business and Social Science* 2, no.2 (2011):169, accessed July 15, 2014, url: http://www.ijbssnet.com/journals/Vol._2_No._2%3B_February_2011/20.pdf.

of the customer. The conventional banks, before providing finance require the person to possess some capital and banks charge interest on the finance provided by the bank to its customer. The purpose of conventional banks is to provide the fund to those projects and ventures which are most productive, efficient and beneficial.[87] In conventional banking system, when bank grants finance, it reimburses the principle amount as well as interest amount regardless the project is successful or not. While in Islamic banking system, the pattern of sharing of profit and losses is different. In *mudarabah* agreement the customer *(rabb-al-mal)* will bear all losses but profit is distributed between bank and customer according to the agreed ratio between them and in *musharakah* agreement both parties the bank and the customer bear the losses as well as share the profits.[88]

2.5.3 Oversight of *Shariah* Supervisory Board

The model of Islamic banks is based on trade; they actively participate in production process, trade and activities. All countries have established *Shariah* supervisory authority at the central banks. Islamic banks have *Shariah* supervisory authority in which there are many *Shariah* scholars who give their opinion on matters relating to Islamic banks. A *Shariah* Supervisory Board (SSB) was established at the State Bank of Pakistan, which controls all the actions of Islamic banking and financial institution and is effectively fulfilling its responsibilities. The SSB has a minimum five members,[89] at least two *Shariah* scholars, one chartered accountant, a lawyer and a banker. The board ensures the compliance of Islamic banks with the *Shariah* standards. While the conventional banking business model is not based on trade and

---

[87] Kyn Brown, M.Kabir and Michael Skully, "Operational Efficiency and Performance of Islamic Banks", in *Hand Book of Islamic Banking,* ed. M. Kabir Hassan and Mervyn K. Lewis (Cheltenham: Edward Elgar Publishing limited, 2007), 97-99, url; http://www.kantakji.com/media/2129/b029.pdf.
[88] Ibid.
[89] www.sbp.org.com (accessed15 Sep., 2013).

return on short term deposits. Whereas, in Islamic banking system the return on principle amount is not fixed and predetermined but variable. The Islamic banks accept deposits through *mudarabah* and *musharakah* mechanism. Profit of depositor in Islamic banks depends on the outcome of investment made by bank.[92]

The purpose of Islamic financial institution is to provide an Islamic environment to the Muslim society. Therefore, Islamic banks and conventional banks must legislate and regulate separately.

[92] Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking", *International Journal of Business and Social Science* 2, no.2 (2011):169.

2.6 List of Islamic Banks and Islamic Banking Branches of Conventional Banks[93]

Table 1: Islamic Banks and Islamic Banking Branches of Conventional Banks

Serial No.	Name of Banks
Islamic Banks	
1.	Meezan Bank Ltd
2.	Dubai Islamic Bank Pakistan Ltd
3.	Bank Islami Pakistan Ltd.
4.	Burj Bank Ltd.
5.	AlBaraka Bank (Pakistan) Ltd.
Islamic Banking Branches of Conventional Banks	
1.	Askari Bank Ltd.
2.	Bank Alfalah Ltd
3.	Habib Bank Ltd
4.	Muslim Commercial Bank Ltd
5.	Soneri Bank Ltd
6.	The Bank of Khyber
7.	United Bank Ltd.
8.	Bank Al Habib Ltd
9.	Faysal Bank Ltd.
10.	Habib Metropolitan Bank
11.	National Bank of Pakistan
12.	Standard Chartered Bank
13.	The Bank of Punjab
14.	Silk Bank Ltd

[93]Quarterly Compendium: Statistics of the Banking System [June 2013], url: http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20list%20of%20islamic%20banks (accessed Jan. 31, 2014).

2.7. Current Status of Islamic Banking System in Pakistan

On 15th September, 2003 State Bank of Pakistan has established Islamic Banking Department (IBD),[94] whose function was to promote and develop Islamic banking industry in compliance with the *Shariah* rulings and also to promote Islamic banking as a parallel system to conventional banking industry. The State Bank of Pakistan is the regulator of banking sector for both conventional and Islamic banks and promotes both banking sector.

During the last few years, Islamic banking in Pakistan has shown a significant growth and development. The State Bank of Pakistan (SBP) has been promoting Islamic banking industry and has got encouraging response. Due to success and growth of Islamic banking system it is expected that in future, many conventional banks will shift their businesses towards Islamic banking system. According to the State Bank of Pakistan the total assets of Islamic banks were 8.8 billion dollars at the end of September, 2013. Presently, there are 5 full-fledged Islamic banks and 14 Islamic banking branches of conventional banks (June 30, 2013). Meezan Bank Ltd[95] is the first and largest Islamic banking network and it commenced its business on March 20, 2002. It has now three hundred and fifty branches in different parts of the country. Al Baraka[96] is a multinational/foreign bank based in Bahrain and commenced its business at Lahore in 1991. It has now ninety four branches in Pakistan. On April 7, 2006 BankIslami[97] opened its branch in Karachi. Presently, BankIslami has one hundred and fifty branches across the nation. In 1975, Dubai Islamic Bank[98] was

[94] http://www.sbp.org.pk/departments/ibd.htm#h3 (accessed Feb. 10, 2014).
[95] http://www.meezanbank.com (accessed Feb. 19, 2014).
[96] http://www.albaraka.com.pk/al-baraka/ (accessed Feb. 19, 2014).
[97] http://www.bankislami.com.pk/about_us/?id=1 (accessed Feb. 19, 2014).
[98] http://www.dibpak.com/About-Us/DIB-Pakistan (accessed Feb. 19, 2014).

established in Dubai and its branches are also operating in Pakistan. By now, it has almost one hundred and twenty five branches in Pakistan. Burj Bank[99] is fifth full-fledging Islamic bank in Pakistan and it has ninety two branches in Pakistan. National Bank Ltd introduced Islamic window to its 10 branches in 2012. Other banks such as Muslim Commercial Bank (MCB), Summit Bank Ltd, and Dubai Islamic Bank also expanded their existing businesses because Islamic banks are providing a parallel opportunity to conventional banking system.

Kazi Abdul Mukhatir[100] said that the State Bank of Pakistan has developed a five year strategic plan (2014-2018)[101] for Islamic banking of Pakistan. This strategic plan would define the strategies and plan for Islamic banking sector. In the development of plan, the State Bank of Pakistan would expect meaningful and active involvement. The performance of Islamic banking and finance has put positive impact on the banking sector. That is why presently in Pakistan; Islamic banking has 964 branches all over the country. During the last few decades, Islamic banks have shown encouraging growth and development in Pakistan as there are now 30 Islamic mutual funds and 5 *Takaful* operators. In 2010-2012, State Bank of Pakistan issued worth of 369 billion *sukuk*. The issuance of *sukuk* on quarterly basis increased the tradability and market confidence. Presently, in more than 75 countries, Islamic financial industry comprises of 430 Islamic Financial Institutions (IFI) and Islamic banks and 191 conventional banks having Islamic banking branches.

[99] http://www.burjbankltd.com/ (accessed Feb. 19, 2014).
[100] Kazi Abdul Muktadir(Deputy Governor State Bank of Pakistan) State Bank developing new five year strategic plan for Islamic banking industry (September 04,2012).
[101]http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf (accessed March 10, 2014).

The vision statement of the Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP)[102] is: "To make Islamic Banking, the banking of first choice for the providers and users of financial services."

2.8. Challenges Posed to the Islamic Banking Industry[103]

The Islamic banks are showing encouraging response, but still there are some challenges faced by Islamic banking industry. These challenges are:

- There is absence of special legal and regulatory laws for Islamic banks in Pakistan.
- Creation of Islamic inter-bank market and solution for liquidity management.
- There is a need to introduce new Islamic banking products and new research must be conducted for growth and development of Islamic banking and finance.
- Lack of awareness at different levels including customers, bankers, researchers and regulators due to the absence of special Islamic banking laws.
- The Islamic banking practices vary from bank to bank. Therefore, there is a need of harmonization and standardization of rules relating to Islamic finance. It will help to gain the customer's confidence towards Islamic banking and finance.
- The regulators of Islamic finance have limited number of expert *Shariah* advisors.

---

[102] http://www.sbp.org.pk/departments/ibd.htm#h3 (accessed June 15, 2014).

[103] Ahmed Ali Siddique, "Islamic Banking Industry Growing Aimed Challenges", *Journal of Islamic Banking and Finance* 30, no.1 (2013).

There is a continuous growth and success in Islamic banking industry but still Islamic banking and financial institutions faced some problems. Presently, the most important issue posed to Islamic banking industry is the absence of effective legal and regulatory framework. Now, this is a time to resolve such problems so that the industry may work more effectively and efficiently.

CHAPTER 3

LEGAL FRAMEWORK OF ISLAMIC BANKS IN DIFFERENT COUNTRIES

3.1 Introduction

In our world, the independent states are recognized through their sovereignty. When a country gets independence, it formulates laws, legal systems and legal institutions for its state. The countries codify different set of laws according to the needs of their people. The development of Islamic jurisprudence in Islamic history was mainly by the work of the jurists, *Shariah* scholars and the court records. The state in the early stage of the Islamic history never codified Islamic law in the form of codes, statues, laws and regulations. The Holy Prophet (Peace Be Upon Him) himself codifies the first constitution in the world, 'The Charter of Madinah' (*As-Sahifah Al-Madinah*).[104] It was an example of publication of first law in a codified form. In 19th century, during the era of Ottoman Empire, an attempt was made to codify Islamic jurisprudence and a code of civil law was published known as the '*Majallah Al-Ahkam Al-Adliyya*'.[105] After this empire many Islamic states introduced legal and regulatory systems of their own and they adopted laws from English Common Law System or French Civil Law System. The basic elements of each system were the same i.e., the executive, the legislature and the judiciary. They differed in reference to the

[104] http://islamicencyclopedia.org/public/index/topicDetail/id/247 (accessed June 05, 2014).
[105] The *Majallah Al-Ahkam Al-Adliyya'* is an Islamic civil law. It contains the rules relating to Islamic transactions.

procedural law and substantive law and these differences determined the legal framework to be adopted for Islamic finance. Hence, the development of legal framework for Islamic financial sector is in its developing stage and to create a vibrant and sound Islamic finance industry there is a need of effective legislation for Islamic financial industry.[106]

A system that is used to enforce and interpret the law is said to be a legal system. A legal system is a system adopted by a particular jurisdiction, such as a civil law system or a common law system. In every country, there are a few legal frameworks operating, such as legal framework for commerce and trade, legal framework for real property administration and land, legal framework for financial institutions, legal framework for Islamic banking and finance and so on. Today, there are three main legal systems i.e., the common law system, civil law system[107] and the Islamic law system (*Shariah*).[108]

Shariah is a legal system which is based on the principles laid down by the *Holy Quran* and the *Sunnah*. *Shariah* is Islamic law, and it is a set of laws, principles, norms and values that make up the Islamic way of life. *Shariah* (Islamic law) is universal, applicable and complete in all its aspects as compared to civil law system and common law system which are still developing with the passage of time.[109]

[106]Menara Tun Razak and Jalan Raja Lautt, *Islamic Financial System Principles and Operations (*Kuala Lumpur: International Shariah Research Academy for Islamic Finance, 2012), 736-737.

[107] Civil law is a kind of legal system in which laws are legislated by the represented of the government or by the parliament of the state. Continental law, Roman law and Napoleonic law are other names of the civil law system.

[108] Ibid, 737.

[109] Ibid.

3.2 Legal Framework for Islamic Finance

Globally, there are different sets of legal system such as civil law, common law and Islamic law system. The countries adopt different legal and regulatory frameworks for Islamic banking and finance. The legal framework of Islamic banking and finance consists of following factors:[110]

- The legislative bodies or the parliament promulgates the laws relating to Islamic banking institutions.
- The enactment of Islamic banking laws.
- The executive or regulatory authorities who will oversee the enforcement and implementation of relevant law.
- The individuals and institutions that are subject to the law.
- The judicial bodies to adjudicate or rule on disputes and issues relating to the particular matter.

A legal framework of a particular industry is effective and would be characterized by:[111]

- It provides an environment that helps the development of the particular industry.
- A legal framework allows investors to access to the primary and secondary capital market.
- A legal framework for Islamic banks develops a reliable and credible forum for the peaceful settlement of dispute in the Islamic banking transactions.

[110] Razak and Lautt, *Islamic Financial System Principles and Operations*, 743.
[111] Ibid.

through trading, leasing, profit and loss sharing mechanism and using other legitimate means to earn money. While Islamic banks must comply with the *Shariah* principles and prohibit unethical practices, the conventional banking system is purely based on interest based financial system and is based on financing profitable projects.[84] The principles of conventional banks are based on man-made laws. Whereas interest based transactions are completely forbidden in *Shariah* and as mentioned in number of *Quranic* verses:

"*O you who have believed, do not consume usury, doubled and multiplied, but fear Allah; that you may be successful.*"[85]

2.5.2 Financing and Investments in Islamic Banks

Conventional banks and Islamic banks provide credit facility to its customers but nature of financial agreement is different in both institutions. Conventional banks provide credit facility and charge fixed amount of interest on principle amount whereas, Islamic banking system does not charge interest on loan, they take profit on investments and such profit is distributed among the customer and the bank. Conventional banks offer three kinds of loans; short-term loans, long-term loan and overdrafts. Islamic banks issued *qard hasan* (interest free loans) and they cannot charge interest because it is against the principles of *Shariah*.[86]

In Islamic banking system the bank shares profit as well as loss with the customer through different mechanism such as in *mudarabah* and *musharakah*. Sometime banks act as a partner of the customer and sometime they act like an agent

---

[84] http://www.bankislam.com.my/en/documents/shariah/broaddistinctionbetweenislamicconventional.pdf (accessed Jan. 26, 2014).

[85] Al-Quran 3:130

[86] Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking", *International Journal of Business and Social Science* 2, no.2 (2011):169, accessed July 15, 2014, url: http://www.ijbssnet.com/journals/Vol._2_No._2%3B_February_2011/20.pdf.

of the customer. The conventional banks, before providing finance require the person to possess some capital and banks charge interest on the finance provided by the bank to its customer. The purpose of conventional banks is to provide the fund to those projects and ventures which are most productive, efficient and beneficial.[87] In conventional banking system, when bank grants finance, it reimburses the principle amount as well as interest amount regardless the project is successful or not. While in Islamic banking system, the pattern of sharing of profit and losses is different. In *mudarabah* agreement the customer (*rabb-al-mal)* will bear all losses but profit is distributed between bank and customer according to the agreed ratio between them and in *musharakah* agreement both parties the bank and the customer bear the losses as well as share the profits.[88]

2.5.3 Oversight of *Shariah* Supervisory Board

The model of Islamic banks is based on trade; they actively participate in production process, trade and activities. All countries have established *Shariah* supervisory authority at the central banks. Islamic banks have *Shariah* supervisory authority in which there are many *Shariah* scholars who give their opinion on matters relating to Islamic banks. A *Shariah* Supervisory Board (SSB) was established at the State Bank of Pakistan, which controls all the actions of Islamic banking and financial institution and is effectively fulfilling its responsibilities. The SSB has a minimum five members,[89] at least two *Shariah* scholars, one chartered accountant, a lawyer and a banker. The board ensures the compliance of Islamic banks with the *Shariah* standards. While the conventional banking business model is not based on trade and

---

[87] Kyn Brown, M.Kabir and Michael Skully, "Operational Efficiency and Performance of Islamic Banks", in *Hand Book of Islamic Banking,* ed. M. Kabir Hassan and Mervyn K. Lewis (Cheltenham: Edward Elgar Publishing limited, 2007), 97-99, url; http://www.kantakji.com/media/2129/b029.pdf.

[88] Ibid.

[89] www.sbp.org.com (accessed15 Sep., 2013).

production activities, they only act as a money lender. In conventional banking system there is no such kind of *Shariah* Supervisory Board.[90]

2.5.4 Islamic Mortgage Financing and Conventional Mortgage Financing

In conventional banks, the customer borrows money from the bank to purchase a property and repays the said amount as well as the interest amount charged on the principle amount. The addition amount on principle amount is purely an interest which is clearly against the principles of *Shariah.* While in Islamic banking system, in order to purchase a property, the bank shares funds with the customer, hence, the bank and the customer become joint owner of the property. In order to take the whole property, the customer purchases the whole share of the bank and pay rent to the bank for use of bank's part in the property. After a specific time when customer has paid all money to the bank, he becomes sole owner of the property. In Islamic mortgage finance, the lessee is liable to pay rent when possession is transferred to the lessee. If there is any delay in transfer of possession the lessee is not liable for rent. In conventional mortgage finance, the lessee is liable for payment of rent when bank purchased the property.[91]

2.5.5 Deposits

Both Islamic banks and conventional banks collect deposits from their customers. The difference between Islamic banking and conventional banking system is the return on such deposits. Under conventional banking system, the return on principle amount is predetermined and fixed between the bank and its customers. Conventional banks offer higher rate of return on long term deposits and lower rate of

---

[90] Kyn Brown, M.Kabir and Michael Skully, "Operational Efficiency and Performance of Islamic Banks", 97-99.

[91] http://www.mib.com.mv/blog/guide-to-islamic-banking/difference-between-conventional-and islamic-banking (accessed Jan. 26, 2014).

return on short term deposits. Whereas, in Islamic banking system the return on principle amount is not fixed and predetermined but variable. The Islamic banks accept deposits through *mudarabah* and *musharakah* mechanism. Profit of depositor in Islamic banks depends on the outcome of investment made by bank.[92]

The purpose of Islamic financial institution is to provide an Islamic environment to the Muslim society. Therefore, Islamic banks and conventional banks must legislate and regulate separately.

---

[92] Muhammad Hanif, "Differences and Similarities in Islamic and Conventional Banking", *International Journal of Business and Social Science* 2, no.2 (2011):169.

2.6 List of Islamic Banks and Islamic Banking Branches of Conventional Banks[93]

Table 1: Islamic Banks and Islamic Banking Branches of Conventional Banks

Serial No.	Name of Banks
	Islamic Banks
1.	Meezan Bank Ltd
2.	Dubai Islamic Bank Pakistan Ltd
3.	Bank Islami Pakistan Ltd.
4.	Burj Bank Ltd.
5.	AlBaraka Bank (Pakistan) Ltd.
	Islamic Banking Branches of Conventional Banks
1.	Askari Bank Ltd.
2.	Bank Alfalah Ltd
3.	Habib Bank Ltd
4.	Muslim Commercial Bank Ltd
5.	Soneri Bank Ltd
6.	The Bank of Khyber
7.	United Bank Ltd.
8.	Bank Al Habib Ltd
9.	Faysal Bank Ltd.
10.	Habib Metropolitan Bank
11.	National Bank of Pakistan
12.	Standard Chartered Bank
13.	The Bank of Punjab
14.	Silk Bank Ltd

[93]Quarterly Compendium: Statistics of the Banking System [June 2013], url: http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20list%20of%20islamic%20banks (accessed Jan. 31, 2014).

2.7. Current Status of Islamic Banking System in Pakistan

On 15th September, 2003 State Bank of Pakistan has established Islamic Banking Department (IBD),[94] whose function was to promote and develop Islamic banking industry in compliance with the *Shariah* rulings and also to promote Islamic banking as a parallel system to conventional banking industry. The State Bank of Pakistan is the regulator of banking sector for both conventional and Islamic banks and promotes both banking sector.

During the last few years, Islamic banking in Pakistan has shown a significant growth and development. The State Bank of Pakistan (SBP) has been promoting Islamic banking industry and has got encouraging response. Due to success and growth of Islamic banking system it is expected that in future, many conventional banks will shift their businesses towards Islamic banking system. According to the State Bank of Pakistan the total assets of Islamic banks were 8.8 billion dollars at the end of September, 2013. Presently, there are 5 full-fledged Islamic banks and 14 Islamic banking branches of conventional banks (June 30, 2013). Meezan Bank Ltd[95] is the first and largest Islamic banking network and it commenced its business on March 20, 2002. It has now three hundred and fifty branches in different parts of the country. Al Baraka[96] is a multinational/foreign bank based in Bahrain and commenced its business at Lahore in 1991. It has now ninety four branches in Pakistan. On April 7, 2006 BankIslami[97] opened its branch in Karachi. Presently, BankIslami has one hundred and fifty branches across the nation. In 1975, Dubai Islamic Bank[98] was

---

[94] http://www.sbp.org.pk/departments/ibd.htm#h3 (accessed Feb. 10, 2014).
[95] http://www.meezanbank.com (accessed Feb. 19, 2014).
[96] http://www.albaraka.com.pk/al-baraka/ (accessed Feb. 19, 2014).
[97] http://www.bankislami.com.pk/about_us/?id=1 (accessed Feb. 19, 2014).
[98] http://www.dibpak.com/About-Us/DIB-Pakistan (accessed Feb. 19, 2014).

established in Dubai and its branches are also operating in Pakistan. By now, it has almost one hundred and twenty five branches in Pakistan. Burj Bank[99] is fifth full-fledging Islamic bank in Pakistan and it has ninety two branches in Pakistan. National Bank Ltd introduced Islamic window to its 10 branches in 2012. Other banks such as Muslim Commercial Bank (MCB), Summit Bank Ltd, and Dubai Islamic Bank also expanded their existing businesses because Islamic banks are providing a parallel opportunity to conventional banking system.

Kazi Abdul Mukhatir[100] said that the State Bank of Pakistan has developed a five year strategic plan (2014-2018)[101] for Islamic banking of Pakistan. This strategic plan would define the strategies and plan for Islamic banking sector. In the development of plan, the State Bank of Pakistan would expect meaningful and active involvement. The performance of Islamic banking and finance has put positive impact on the banking sector. That is why presently in Pakistan; Islamic banking has 964 branches all over the country. During the last few decades, Islamic banks have shown encouraging growth and development in Pakistan as there are now 30 Islamic mutual funds and 5 *Takaful* operators. In 2010-2012, State Bank of Pakistan issued worth of 369 billion *sukuk*. The issuance of *sukuk* on quarterly basis increased the tradability and market confidence. Presently, in more than 75 countries, Islamic financial industry comprises of 430 Islamic Financial Institutions (IFI) and Islamic banks and 191 conventional banks having Islamic banking branches.

[99] http://www.burjbankltd.com/ (accessed Feb. 19, 2014).

[100] Kazi Abdul Muktadir(Deputy Governor State Bank of Pakistan) State Bank developing new five year strategic plan for Islamic banking industry (September 04,2012).

[101] http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategy%20Paper-Final.pdf (accessed March 10, 2014).

The vision statement of the Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP)[102] is: "To make Islamic Banking, the banking of first choice for the providers and users of financial services."

2.8. Challenges Posed to the Islamic Banking Industry[103]

The Islamic banks are showing encouraging response, but still there are some challenges faced by Islamic banking industry. These challenges are:

- There is absence of special legal and regulatory laws for Islamic banks in Pakistan.
- Creation of Islamic inter-bank market and solution for liquidity management.
- There is a need to introduce new Islamic banking products and new research must be conducted for growth and development of Islamic banking and finance.
- Lack of awareness at different levels including customers, bankers, researchers and regulators due to the absence of special Islamic banking laws.
- The Islamic banking practices vary from bank to bank. Therefore, there is a need of harmonization and standardization of rules relating to Islamic finance. It will help to gain the customer's confidence towards Islamic banking and finance.
- The regulators of Islamic finance have limited number of expert *Shariah* advisors.

---

[102] http://www.sbp.org.pk/departments/ibd.htm#h3 (accessed June 15, 2014).

[103] Ahmed Ali Siddique, "Islamic Banking Industry Growing Aimed Challenges", *Journal of Islamic Banking and Finance* 30, no.1 (2013).

There is a continuous growth and success in Islamic banking industry but still Islamic banking and financial institutions faced some problems. Presently, the most important issue posed to Islamic banking industry is the absence of effective legal and regulatory framework. Now, this is a time to resolve such problems so that the industry may work more effectively and efficiently.

CHAPTER 3

LEGAL FRAMEWORK OF ISLAMIC BANKS IN DIFFERENT COUNTRIES

3.1 Introduction

In our world, the independent states are recognized through their sovereignty. When a country gets independence, it formulates laws, legal systems and legal institutions for its state. The countries codify different set of laws according to the needs of their people. The development of Islamic jurisprudence in Islamic history was mainly by the work of the jurists, *Shariah* scholars and the court records. The state in the early stage of the Islamic history never codified Islamic law in the form of codes, statues, laws and regulations. The Holy Prophet (Peace Be Upon Him) himself codifies the first constitution in the world, 'The Charter of Madinah' (*As-Sahifah Al-Madinah*).[104] It was an example of publication of first law in a codified form. In 19^{th} century, during the era of Ottoman Empire, an attempt was made to codify Islamic jurisprudence and a code of civil law was published known as the '*Majallah Al-Ahkam Al-Adliyya*'.[105] After this empire many Islamic states introduced legal and regulatory systems of their own and they adopted laws from English Common Law System or French Civil Law System. The basic elements of each system were the same i.e., the executive, the legislature and the judiciary. They differed in reference to the

[104] http://islamicencyclopedia.org/public/index/topicDetail/id/247 (accessed June 05, 2014).
[105] The *Majallah Al-Ahkam Al-Adliyya'* is an Islamic civil law. It contains the rules relating to Islamic transactions.

procedural law and substantive law and these differences determined the legal framework to be adopted for Islamic finance. Hence, the development of legal framework for Islamic financial sector is in its developing stage and to create a vibrant and sound Islamic finance industry there is a need of effective legislation for Islamic financial industry.[106]

A system that is used to enforce and interpret the law is said to be a legal system. A legal system is a system adopted by a particular jurisdiction, such as a civil law system or a common law system. In every country, there are a few legal frameworks operating, such as legal framework for commerce and trade, legal framework for real property administration and land, legal framework for financial institutions, legal framework for Islamic banking and finance and so on. Today, there are three main legal systems i.e., the common law system, civil law system[107] and the Islamic law system (*Shariah*).[108]

Shariah is a legal system which is based on the principles laid down by the *Holy Quran* and the *Sunnah*. *Shariah* is Islamic law, and it is a set of laws, principles, norms and values that make up the Islamic way of life. *Shariah* (Islamic law) is universal, applicable and complete in all its aspects as compared to civil law system and common law system which are still developing with the passage of time.[109]

---

[106]Menara Tun Razak and Jalan Raja Lautt, *Islamic Financial System Principles and Operations* (Kuala Lumpur: International Shariah Research Academy for Islamic Finance, 2012), 736-737.

[107] Civil law is a kind of legal system in which laws are legislated by the represented of the government or by the parliament of the state. Continental law, Roman law and Napoleonic law are other names of the civil law system.

[108] Ibid, 737.

[109] Ibid.

3.2 Legal Framework for Islamic Finance

Globally, there are different sets of legal system such as civil law, common law and Islamic law system. The countries adopt different legal and regulatory frameworks for Islamic banking and finance. The legal framework of Islamic banking and finance consists of following factors:[110]

- The legislative bodies or the parliament promulgates the laws relating to Islamic banking institutions.
- The enactment of Islamic banking laws.
- The executive or regulatory authorities who will oversee the enforcement and implementation of relevant law.
- The individuals and institutions that are subject to the law.
- The judicial bodies to adjudicate or rule on disputes and issues relating to the particular matter.

A legal framework of a particular industry is effective and would be characterized by:[111]

- It provides an environment that helps the development of the particular industry.
- A legal framework allows investors to access to the primary and secondary capital market.
- A legal framework for Islamic banks develops a reliable and credible forum for the peaceful settlement of dispute in the Islamic banking transactions.

[110] Razak and Lautt, *Islamic Financial System Principles and Operations*, 743.
[111] Ibid.

These characteristics seem straightforward and plain but the architecture and composition of a complete and effective legal framework is quite difficult. An effective and proper legal framework facilitates and allows fair and efficient operations of capital market, efficient formation and movement of capital and stability of money market. The effective legal framework protects investors, provides an efficient, fair and transparent market and also overcomes risk to the investors.

McMillen[112] explains the meaning of legal framework, as a framework that is not only limited to the enactment of substantive laws or special laws for Islamic banking and finance but also provides stability to the institutions and promotes the concept of rule of law in the society. An effective and proper legal framework for Islamic banking sector must be based upon the principles of *Shariah* that makes it different from conventional banking sector because the basis of Islamic banking system is different from conventional banking system. The government of the state should legitimately exercise its powers and enforce a written law according to the established procedure. For the development of Islamic financial industry, effective and efficient legal framework covers accountability, disclosure and transparency and provides a fair, efficient and transparent market to the investors.[113]

The Islamic banking industry is in its nascent stage, whereby complete and effective legal framework had not yet been laid down for this industry. To make it in

[112] Michael McMillen is internationally recognized for his work in Islamic finance and project finance. His transactional work focuses on the Americas, Europe, the Middle East and Asia. He publishes and speaks throughout the world on Islamic finance and project and infrastructure finance. He has twice been a recipient of the Euromoney award for Best Legal Advisor in Islamic Finance (2004 and 2007) and has also received the Sheikh Mohammed Bin Rashid Al-Maktoum award for Best Legal Advisor in Islamic Finance for North America.

[113] Ibid, 744.

accordance with the demand of the public the authorities have to:[114]

- Apply conventional banking laws on Islamic banking institutions.
- Amend or adopt the existing conventional banking laws in accordance with Islamic laws or principles.
- Create special Islamic banking laws that particularly deal with Islamic banking sector.

3.3 Legal Framework of Islamic Banking in Different Countries, Case Study of Pakistan, Malaysia and Bahrain

In order to provide a comprehensive setup to the Islamic banks, it is necessary that either there must be specific laws for Islamic banks or presence of general banking laws which deal with the operation of Islamic banks and their relationship with conventional banks and central banks. Such as Islamic banking legal framework gives detailed directions relating to the modes of Islamic finance, investments, licensing, civil and criminal liabilities and also state the powers of regulating authorities.[115]

Different countries adopted different legal framework for Islamic banking and finance. There are many countries that apply conventional banking laws on Islamic banking system like Algeria, Australia, Canada China, Egypt, UK, US, Switzerland and Germany. Some countries apply existing conventional banking laws but with certain amendments such as in Pakistan, Bahrain, Turkey, Jordan and Qatar. There are many countries that made a complete separate framework for Islamic banks and such

[114] Ibid 745.
[115] Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision", in *International Monetary Fund, Monetary and Exchange Affairs Department* (Distributors William E. Alexander and Charles Enoch, March 1998), 15.

a) Banking Companies Ordinance, 1962[122]

The Banking Companies Ordinance was enacted under the presidential order in 1962. In Pakistan, Islamic banks as well as conventional banks conduct their business according to Banking Companies Ordinance, 1962. The important aspects of Banking Companies Ordinance, 1962 includes business of banking companies, winding up of banking companies and suspension of business, banking mohtasib and punishments. Amendments were made in the Banking Companies Ordinance, 1962 to fulfill the needs of Islamic banks as well. Some amendments related to Islamic banks are as follows.

i. Section 5 was amended, it defines the "creditor as a person from whom deposits have been received on the basis of participation in profit and loss and a banking company or financial institution from which financial accommodation or facility has been received on the basis of participation in profit and loss, mark-up in price, hire-purchase, lease, or otherwise."

ii. Section 23 of Banking Companies Ordinance, 1962 was amended to allow existing banks to set up subsidiaries for Islamic banks. This law also prohibits interest in any form.

iii. Sec 26A was inserted in BCO, 1962 which clearly describes that banking companies accept deposits on the basis of profit and loss sharing and prohibiting interest in any form.

---

[122] http://www.bu.edu/bucflp/files/2012/01/Banking-Companies-Ordinance-of-1962-and-Rules-of 1963-consumer-protection-related.pdf (accessed Aug. 27, 2014).

b) Financial Institutions (Recovery of Finances) Ordinance, 2001[123]

The Financial Institutions (Recovery of Finances) Ordinance, 2001 was enacted under a presidential order in 2001. Presently, the recovery of all kinds of loans, finances whether interest based or mark-up based, lease financing, credit cards, letters of credit, long term and short term finance certificates etc., in other words all kinds of consumer financing, house building finances, investment financing, lease financing, development financing etc. are covered under this law. It is a Special Law as distinguished from general law. It is an established principle of law that a special law always prevails over the general law.[124]

The purpose of establishment of banking court is to provide speedy justice to the aggrieved persons. The main concern of the Ordinance is the recovery of their outstanding dues. It has sufficient and effective provisions for the recovery of the dues.[125]

The Banking Courts deal with all banking cases relating to Islamic and conventional banks. The Federal government has established Banking Courts in Pakistan and also appoints judges for the said Courts. Under Sec. 7 of the Ordinance the Banking Courts have all the powers of a civil court under the Civil Procedure Code (CPC) and at the same time also has all the powers of a criminal court which a Sessions Court possesses under the Criminal Procedure Code (CrPC).

[123] http://www.bu.edu/bucflp/files/2012/01/Financial-Institutions-Recovery-of-Finances Ordinance.pdf (accessed Aug. 27, 2014).
[124] Ibid.
[125] Ibid.

In *Messra Victor Electronics Appliances Industries vs. Habib Bank Limited and others*[126] case, there was contravening of the provision of sec 9 of Financial Institutions (Recovery of Finances) Ordinance, 2001. In this case the plaintiff filed a suit in civil court under ordinary law and civil court gave judgement in favour of plaintiff. The defendant filed an appeal to return the case to Banking Court. The plaintiff pleaded before the Supreme Court that "the jurisdiction of a court could be created through a concession or an agreement between the parties." The Supreme Court dismissed the appeal and declared that only Banking Courts have jurisdiction to adjudicate financial matters.

In National Bank of Pakistan Limited vs. S.G. Fiber Private Limited and Others,[127] the relationship between underwriters and issuer were not established as a customer and financial institution according to section 2(d) of Financial Institutions (Recovery of Finances) Ordinance, 2001. So, Civil Court has jurisdiction to decide the matter and not by the Banking Courts.

In both of these cases *Messra Victor Electronics Appliances Industries vs. Habib Bank Limited and Others* and *National Bank of Pakistan Limited vs. S.G. Fiber Private Limited and Others,* it was difficult for the person to determine the jurisdiction of courts. The ambit of the Banking Court is not clear. The matters which came under Banking Court jurisdiction were heard by Civil Court and those matters which came under Civil Court jurisdiction were heard by Banking Court, the parties claimed that there were financial institution and customer so Banking Courts should adjudicate upon the matter. This was time consuming and caused delays in justice. The scope of Banking Courts should be very clear to achieve the purpose of Financial Institutions

[126] 2010 Corporate Law Decisions 585.
[127] 2004 Corporate Law Decisions 689.

(Recovery of Finances) Ordinance, 2001 and establishment of Banking Courts. And it is also suggested that the establishment of *Shariah* commercial courts which exclusively deals with the Islamic banking and finance matters.

c) Circulars Issued by IBD of SBP

The Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP) issues circulars for Islamic banks and such circulars are binding in nature.[128] It provides guidelines relating to permissible modes of Islamic finance, fit and proper criteria for the *Shariah* advisors, instructions for profit and loss distribution and pool management, adoption of AAOIFI standards and *Shariah* Governance Framework for Islamic Banking Institutions (IBIs).

d) Companies Ordinance, 1984[129]

The Companies Ordinance, 1984 is a general law that was enacted under the presidential order dated February, 1984. It deals with all companies (public or private) incorporated in Pakistan. It provides a complete provision relating to the formation of the company. And all public and private companies incorporated in Pakistan must comply the provisions of Companies Ordinance, 1984.

From the above discussion it is clear that in Pakistan special Islamic banking law does not exist. The working of Islamic banking institutions is without clear and proper legal framework, the absence of effective legal framework of Islamic banks creates serious concerns. Such as due to absence of special Islamic banking laws, the Islamic banking practices vary from bank to bank. It may affect the customer's confidence. There is a need of *Shariah* interpretation and definition of various kinds of

---

[128] 2004 Corporate Law Decision 257.
[129] http://www.secp.gov.pk/corporatelaws/pdf/CO1984_%20Feb09.pdf (accessed Aug. 27, 2014).

countries are considered as a financial hub of Islamic banking sector. The best known example is Malaysia.[116]

In many Muslim countries company laws and banking laws follow western pattern. Hence, many provisions of these laws are against the principles of Islamic banking method. Even if parties conclude their agreements according to Islamic law, it is very difficult to interpret and enforce the relevant laws and it also becomes costly for the parties. In many Islamic financial cases, local laws are applied instead of Islamic banking laws due to lack of proper enforcement of Islamic laws. For example in the case of, *Bank Kerjasama Rakyat Malaysia Berhad v Emcee Corporation Sdn Bhd,*[117] where the learned judge held that:

> As was mentioned at the beginning of this judgement, the facility is an Islamic banking facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility was given under conventional banking. The charge is a charge under the National Land Code. The remedy available and sought is a remedy provided by the National Land Code. The procedure is provided by the Code and the Rules of the High Court 1980. The court adjudicating it is the High Court. So, it is the same law that is applicable, the same order that would be, if made, and same principles that should be applied in deciding the application.

One of the most important and common problem faced by countries is the lack of proper legal framework for Islamic banks. Therefore, it is necessary that Islamic countries must work to enact some specific laws that deal with Islamic banking industry.[118]

Therefore, it is necessary that the Islamic banks should adopt international best practices for their growth and development. To deal with new financial conglomerates

---

[116] Razak and Lautt, *Islamic Financial System Principles and Operations,* 748.

[117] [2003] 2 AMR 177.

[118] Fuad Abdullah Al-Omar and Munawar Iqbal, *Challenges Facing Islamic Banking in the 21st Century* (Massachusetts: Center for Middle Eastern Studies, 1999), 251.

there is a need to put new legal framework for Islamic banking industry.[119] The growth and progress of Islamic banking and finance in Malaysia, Pakistan and Bahrain is discussed under prevailing banking and legal systems and also current legislative framework in these countries

3.3.1 Islamic Banking in Pakistan

In Pakistan, the Islamic banking sector emerged in early 1980s. The first full-fledge Islamic bank of Pakistan is the Meezan Bank Ltd and it commenced its business from March 20, 2002. The State Bank of Pakistan (SBP) regulates banking industry in Pakistan.[120] Currently, in Pakistan there are 5 full-fledged Islamic banks and 14 Islamic banking branches of conventional banks as of June 30, 2013.[121] Despite tough economic conditions, Islamic banking in Pakistan has achieved 10% shares of banking industry in 2013.

3.3.1.1 Statutes Relating With Islamic Banking and Finance in Pakistan

The general laws and guidelines relating to Islamic banking and finance in Pakistan are as follows:

a) Banking Companies Ordinance (BCO), 1962
b) Financial Institutions (Recovery of Finances) Ordinance, 2001
c) Companies Ordinance, 1984
d) Circulars issued by the SBP

---

[119] State Bank of Pakistan, Pakistan 10 Year Strategy Paper For the Banking Sector Reforms (Karachi: State Bank Of Pakistan).

[120] M. Umer Chapra and Tariqullah Khan, *Regulation and Supervision of Islamic Banks* (Jeddah: Islamic Research and Training Institute, 2000), 28, url: http://www.sbp.org.pk/departments/ibd/Regulation_Supervision.pdf.

[121] Quarterly Compendium: Statistics of the Banking System [June 2013] Available on http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20list%20of%20islamic%20banks (accessed Jan. 31, 2014).

contracts, processes and modes of financing. Islamic banking institutions need standardization and harmonization of Islamic banking laws. Similarly, lack of special laws developed and strengthened an environment of uncertainty leading to the short term investments made by Islamic banks and financial institutions in comparison to the long term investments by the conventional banking sector.[130]

At present future evolution of various Islamic modes of finance constraint. Therefore, there is a great need to introduce a *Shariah* complaint mechanism through which Islamic financial institutions are able to develop *Shariah* complaint instruments and risk management system as early as possible. This will lead to the development of a *Shariah* complaint framework, which could bring standardization in the sector.[131]

Presently, there is no law in Pakistan which deals exclusively with the working and establishment of Islamic banking sector. A full-fledged Islamic banking sector is working under conventional banking laws, few directives, guidelines and circulars issued by the State Bank of Pakistan (SBP).[132] All laws dealing with Islamic banks are conventional banking laws while the Islamic banking business is totally different from conventional banking business.[133] Islamic banking industry claims that it is based on principles of *Sharaih* but without proper legal framework it is not possible to claim an interest free Islamic banking system, for example in a case *Muhammad Haq Nawaz vs. Habib Bank Limited*,[134] which was initiated against the Habib Bank Limited contravening the provision of Art. 199 and 203-G of the Constitution of Pakistan 1973

[130] Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* (Edinburgh: Edinburgh University Press Ltd, 2012), 1983.

[131] http://www.shahfoundationbd.org/hannan/article10.html (accessed June 10, 2013).

[132] Muhammad Naveed Chohan and Muhammad Waleed Chohan, "Corporate Governance in Islamic Banking Institutions of Pakistan: Walking Legal and Regulatory Challenges" 8-10.

[133] Zubair Iqbal and Abbas Mirakhor, *Islamic Banking* (Washington D.C.: Library of Congress Cataloging-in-Publication Data, 1987), 25.

[134] 2002 Corporate Law Decisions 330.

"declaration of mark-up/interest as an un-Islamic." In this case there was a documentary agreement between petitioner and respondent that the petitioner must pay the principal amount as well as mark-up. The petitioner's contention was that the mark-up on principal amount is un-Islamic act as declared by the Federal *Shariat* Court (FSC) of Pakistan and he is liable to pay only principal amount and not the mark-up. The High Court decided that, "at the time of contract the petitioner had undertaken to pay the principal amount and all relevant charges, hence, he is under law to fulfill all contractual obligations and liable to pay principal amount along with mark-up and other charges."

In this case, the High Court made the person liable to pay mark-up, while the FSC quoted that "the mark-up is the price of time allowed on a debt which is interest, pure and simple." High Court while concluding this case did not take any serious action against the bank of charging fixed mark-up.

Similarly, in *Dr. M. Aslam Khaki & Others vs. Syed Muhammad Hashim & Others*[135] and *HBFC vs. Rana Muhammad Sharif & Others* in both of these cases the Supreme Court of Pakistan in exercise of its *Shariat* Appellate jurisdiction explained the permissible Islamic modes of finance such as *ijarah, murabaha, bai-moajjal* etc. If there is presence of proper law relating to Islamic banks, there is no need to explain modes of Islamic finance by the court. Due to the absence of special Islamic banking laws, the courts are free to interpret the laws relating to Islamic banks.

Therefore, a proper legal framework is the most important building block for development and sustainable growth of Islamic banking industry. The present legal banking framework of Pakistan does not make clear distinction between Islamic and

[135] Pakistan Law Decisions 2000 SC 225.

conventional banking system. In order to recognize a legal framework of Islamic banks in Pakistan, there is a need of special laws for Islamic banks or amendments in existing laws, a separate part must be introduced in Banking Companies Ordinance, 1962 and it is necessary that changes must be made in laws relating to Islamic banking industry.

3.3.2 Islamic Banking in Malaysia

The growth and success of Islamic banking industry depends on a comprehensive legal framework. Malaysia is considered as a leading hub of Islamic financial industry and it acquires total 25% shares of the retail market. In Malaysia, the Islamic financial institutions are not only bound to comply *Shariah* standards but they are also comply to other statutory laws such as Islamic banking laws and directions issue by the Securities Commission's and the Bank Negara Malaysia (BNM).[136] Dr. Zeti Akhtar Aziz[137] said that: "Today, we have a comprehensive Islamic financial landscape underpinned by strong institutional infrastructure and effective legal, regulatory and *Shariah* framework."[138]

In Malaysia, Islamic banking shows remarkable growth. There are separate Islamic banking laws existing side-by-side with the conventional banking laws. In Malaysia, Islamic financial system was introduced in 1963; the first Islamic bank of Malaysia was the Bank Islam Malaysia Berhad (BIMB), which started its business on

---

[136] Strategic Plan for Islamic Banking Industry of Pakistan, State Bank of Pakistan, Appendix B.

[137] Dr. Zeti Akhtar Aziz is the seventh Governor of Bank Negara Malaysia. She has been governor of central bank of Malaysia since 20th May, 2000.

[138] Tan Sri Dr. Zeti Akhtar Aziz. Governor Bank Negara Malaysia's Speech at the Official Launch of AmIslamic Bank Berhad. Menara AmBank. Kuala Lumpur. 18 May, 2006.

1 July, 1983.[139] The Bank Negara Malaysia (BNM) introduced Islamic banking in Malaysia step-by-step. The first step taken by BNM was to spread the Islamic banking system in country and also make it possible that all the Malaysian can easily access to this system. The BNM after careful consideration allowed the conventional banks to open Islamic banking branches and it was seen as the most efficient and effective method of increasing Islamic banking business within shortest time period and at lowest cost price. Presently, there are sixteen Islamic banks operating in Malaysia.[140]

3.3.2.1 Statutes Relating With Islamic Banking and Finance in Malaysia

The major statutes and enactments in Malaysia dealing to Islamic banking and finance are given as under:

a) Islamic Banking Act, 1983.
b) Banking and Financial Institutions Act, 1989.
c) Companies Act, 1965.

Hereinafter, discussion has been made defining the purposes and principles of the above mentioned enactments separately.

a) Islamic Banking Act, 1983 (IBA)

It was introduced on 7 April, 1983. It is divided into eight parts and sixty sections. Islamic Banking Act broadly deals with licensing of Islamic banks, financial requirement and duties of Islamic banks, ownership, control and management,

[139] Norhashimah Mohd.Yasin, "Legal Aspects of Islamic Banking: Malaysian Experience", *in Islamic banking and finance fundamental and contemporary issues*, ed. Salman Syed Ali and Ausaf Ahmed (Jeddah: Islamic Research and Training Institution), 215.

[140] http://www.bnm.gov.my/index.php?ch=li&cat=islamic&type=IB&fund=0&cu=0 (accessed March 18, 2014).

restrictions on business, international Islamic banking business and powers of supervision and control over Islamic banks.[141]

This Act gives definition of 'Islamic Bank' and 'Islamic Banking Business' under section 2. It also deals with the provisions relating to *Shariah* Advisory Body (SAB). The establishment of *Shariah* Advisory Body under sections 3(5) and section 13A (1) states that at any time the Islamic bank may seek advice from *Shariah* Advisory Body. From section 14-20 explain the duties of Islamic banks in detail.

b) Banking and Financial Institutions Act, 1989 (BAFIA)[142]

The provisions of the Act that deals to the Islamic banking business are:

Section 15(1)(b)(ii) states that "no institution shall hereafter be granted a license to carry on business under a name which includes the word "Islamic" or "Muslim", or any other word or words in any language capable of being construed as indicating that the institution is carrying out Islamic banking business except with the written consent of the minister." The Banking and Financial Institutions Act states that the only authorized institutions can operate Islamic banking activities.

Sections 32 and 124 of BAFIA allow conventional banks and banking institutions to carry Islamic banking activities.

Section 124(3) of the BAFIA states that the Islamic banking and financial institutions may seek advice from the *Shariah* Advisory Council of the Central Bank. Section 124(7) of the BAFIA deals with the interest free banking schemes.

---

[141] http://www.bnm.gov.my/documents/act/en_ib_act.pdf (accessed Aug. 07, 2014).
[142] http://www.bnm.gov.my/documents/act/en_bafia.pdf (accessed Aug. 09, 2014).

c) Companies Act, 1965[143]

The Companies Act, 1965, is a general company law and it is made to govern and administer the formation of company and also explains their functions in detail. This Act gives right to form any type of corporate organization and start operating under the tag of registered company.[144] In Malaysia, first of all a company incorporated through a Companies Act, 1965[145] and after that this company may apply to the Central Bank of Malaysia as a Islamic banking company. There are certain essential requirements which need to be fulfilled by a company to carry Islamic banking business. In Malaysia the Islamic banking licenses are granted by Bank Negara Malaysia. From section 3 to 13A of Islamic Banking Act, 1983, deals with the licensing of Islamic banks.[146]

This is a detail description of legal framework of Islamic banks in Malaysia. It is clear that the Malaysia has well-defined and comprehensive set of legislations with respect to Islamic banking and finance.

3.3.3 Islamic Banking in Bahrain

Islamic financial industry first emerged in Bahrain in 1990s. In Bahrain there are four kinds of Islamic banking groups such as Islamic investment banks, Islamic commercial banks, Islamic banking branches in conventional banks and Islamic offshore banks.[147] The first Islamic bank in Bahrain was Bahrain Islamic Bank that

---

143 http://jpt.moe.gov.my/RUJUKAN/akta/akta%20syarikat.pdf (accessed Oct. 15, 2014).

144 http://www.malaysiacompanysetup.com/2011/12/overview-malaysian-companies-act.html (accessed April 02, 2015).

145 http://www.kpdnkk.gov.my/kpdnkk-theme/images/pdf/CompaniesAct1965.pdf (accessed April 09, 2014).

146 Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, in *Islamic Transaction and Finance Principles and Developments*, ed. Mohammad Hashim Kamali and Sheila Ainon Yussof (Kuala Lampur: International Institute of Advanced Islamic Studies, 2013), 172.

147 Chapra and Khan, *Regulation and Supervision of Islamic Banks*, 27, url: http://www.sbp.org.pk/departments/ibd/Regulation_Supervision.pdf.

was established in 1979.[148] Currently, there are six retail Islamic banks[149] i.e., Al Baraka Islamic Bank B.S.C, Al-Salam Bank -Bahrain B.[150]S.C, Bahrain Islamic Bank B.S.C, Ithmaar Bank B.S.C, Khaleeji Commercial Bank B.S.C and Kuwait Finance House (Bahrain) B.S.C. and eighteen wholesale[151] Islamic banks.[152]

3.3.3.1 Statutes Relating With Islamic Banking and Finance in Bahrain

In Bahrain, there is no existence of any Islamic banking law.[153] However in terms of regulation it is the first country to introduce a detailed and comprehensive framework for Islamic banks.

---

[148] Ausaf Ahmed, "Contemporary Experience of Islamic Banks," in *A Survey book Elimination of Riba from the Economy*, ed. Khurshid Ahmad (Islamabad: Institute of Policy Studies, 1994-1995), 384.

[149] Islamic retail banks are allowed to transact with both residents and non-residents of the Kingdom of Bahrain, and in both Bahrain Dinar and foreign currencies.

[150] http://www.cbb.gov.bh/assets/CBB%20Register/IsBL-Feb014.pdf (accessed March 14, 2014).

[151] Islamic wholesale banks are allowed to transact with residents of the Kingdom of Bahrain and in Bahraini Dinar, subject to the conditions and exemptions specified in Rules.

[152] https://www.cbb.gov.bh/page-p-banking.htm (accessed March 14, 2015).

[153] Strategic Plan For Islamic Banking Industry in Pakistan, Appendix B page 10

The following table shows the Summary of Legal Framework of Islamic Banks in Different Countries.

Table 2: Legal Frameworks of Islamic Banks in Different Countries

	Pakistan	**Malaysia**	**Bahrain**
Banking System	Dual Banking System (Conventional banks/Islamic banks)	Dual Banking System (Conventional banks/Islamic banks)	Dual Banking System (Conventional banks/Islamic banks)
Islamic Banking Laws	• N/A	In Malaysia, Islamic banks follow following legislations: • Islamic Banking Act, 1983. • Banking and Financial Institutions Act, 1989.	• N/A
Definition Of Islamic Banking Business	• N/A	Sec 2 of Islamic Banking Act, 1983 "Islamic banking business means banking business whose aims and operations do not involve any element	• N/A

		which is not approved by the Religion of Islam."	
Definition of Islamic Financial System & Islamic Financial Institutions	• N/A	In Malaysia sec 2(1) of Central Bank of Malaysia Act, 2009: a."Islamic financial business means any financial system which is in consistent with the *Shariah* and subject to the laws enforced by the Bank." b. "Islamic financial institution means any financial institution carrying on Islamic financial transactions."	• N/A

3.4 Licensing of Islamic Banks in Pakistan

In Pakistan, there is no codified law which deals with the licensing of Islamic banks. The Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP) had issued circulars and notifications for Islamic banks.[154] Islamic Banking Department had issued Circular No. 2 in April 29, 2004 which deals with Minimum *Shariah* Regulatory Standard. The Minimum *Shariah* Regulatory Standard has been incorporated and attached four annexure and application form with this circular.[155] This circular deals with the setting up of scheduled Islamic commercial banks based on the principles of *Shariah* in the private sector,[156] setting up of Islamic banking subsidiaries by existing commercial banks, [157] opening of stand-alone branches for Islamic banking by existing banks[158] and fit and proper criteria for appointment of *Shariah* advisors.[159] Such circulars have the official status and if a licensee breaches any instructions to which it is subject shall be liable for penalty under the Banking Companies Ordinance, 1962.[160]

Section 23(1)(aa) of the Banking Companies Ordinance, 1962[161] which provided that the bank could form a subsidiary for "the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the *Holy Quran* and *Sunnah*." The existing commercial banks are, therefore, allowed by State Bank of Pakistan to open Islamic banking subsidiaries. The process of opening a

---

[154] http://www.sbp.org.pk/circulars/circulars.asp (accessed on 23/05/2014).

[155] http://www.sbp.org.pk/ibd/2004/cir02.htm (accessed on 05/06/2014)

[156] http://www.sbp.org.pk/ibd/2004/Setting-up%20of%20IB%20Annex%20I.pdf (accessed June 05, 2014)

[157]http://www.sbp.org.pk/ibd/2004/Settingup%20of%20IB%20Subsidiary%20Annex%20II.pdf (accessed June 05, 2014)

[158] http://www.sbp.org.pk/ibd/2004/Branch%20Opening%20Guidelines%20Annex%20III.pdf (accessed June 05, 2014)

[159] http://www.sbp.org.pk/ibd/2004/F%20&%20P%20Test%20for%20SA.pdf (accessed June 05, 2014).

[160] Ibid

[161] http://www.sbp.org.pk/publications/prudential/ordinance_62.pdf (accessed March 10, 2015).

scheduled Islamic commercial bank and Islamic banking subsidiaries is almost same. The banks may apply to the State Bank of Pakistan, Islamic Banking Department or the Director. There are certain supplementary requirements which have to be fulfilled by the bank such as that the company must be a Public Limited Company and listed in a stock exchange,[162] all financial transactions must be in accordance with *Shariah* principles, modes of finance, minimum paid up capital, capital adequacy guidelines, sponsor directors and during the last year having CAMELS[163] rating of 1, 2 and 3.[164] The first Scheduled and full-fledged Islamic bank of Pakistan is the Meezan Bank Ltd. However, presently there is no Islamic banking subsidiary by existing commercial bank in Pakistan. But now the SBP has been granted license to Muslim Commercial Bank (MCB) to establish Islamic banking subsidiary in Pakistan. The MCB will be the first Islamic banking subsidiary in Pakistan with the name of 'MCB Islamic Bank Ltd'.[165]

State Bank of Pakistan also issue detailed guidelines relating to stand-alone branches for Islamic bank. The State Bank of Pakistan issue license to the bank to open its stand-alone Islamic branch. Presently, there are fourteen conventional banks which have stand-alone branches for Islamic bank. Therefore, the commercial banks in Pakistan that wish to operate Islamic banking branches need to comply the criterion issue by State Bank of Pakistan.

---

[162] http://www.sbp.org.pk/ibd/2004/Setting-up%20of%20IB%20Annex%20I.pdf

[163] http://www.sbp.org.pk/ibd/2004/Settingup%20of%20IB%20Subsidiary%20Annex%20II.pdf (accessed on 24/05/2014).

[163] http://www.sbp.org.pk/ibd/2010/C2-Anexx.pdf (accessed on 13/06/2014).The "CAMELS Rating System" consists of six factors Capital adequacy, Asset quality, Management quality, Earnings, Liquidity and Sensitivity to Market Risk.

[164] http://www.sbp.org.pk/ibd/2004/Setting-up%20of%20IB%20Subsidiary%20Annex%20II.pdf (accessed on 24/05/2014).

[165] Islamic Banking Bulletin June 2014, Islamic Banking Department State Bank of Pakistan, (accessed Nov. 28, 2014), http://www.sbp.org.pk/ibd/bulletin/2014/IBB-Jun-2014.pdf.

Islamic Banking Department Circular No. 2 of 2010 explains the detail criteria for conversion of conventional banking branches into Islamic banking branches.[166] It explains that those conventional banks which have Islamic banking branches can convert other conventional banking branches into Islamic banks after fulfillment of supplementary requirements and approval of the State Bank of Pakistan.

3.5 Alternate Dispute Resolution (ADR) In Islamic Finance

There are many hindrances in the legal framework of Islamic banking and finance. The interest of Islamic finance may need to relocate the settlement of disputes between Islamic banks with other banks and customers to Alternate Dispute Resolution (ADR). Alternate dispute resolution may be defined as "Procedures that serve as alternative to litigation for resolution of disputes." In alternate dispute resolution there is assistance and intervention of an impartial and neutral third party. There are various types of alternate dispute resolution such as arbitration, mediation, mini trial, expert determination, negotiation, *Shariah* arbitration (*tahkim)* etc. This method may be formal through arbitration or informal through mediation and negotiation. The independent tribunal third party, negotiator, arbitrator or mediator resolves the disputes by an award and it is a binding and private process. The third party, negotiator, arbitrator or mediator is either nominated by independent body or by the parties themselves.[167] However, there is no legal obligation on parties to resolve their dispute through arbitration, mediation, negotiation etc., rather it is discretion of

166 http://www.sbp.org.pk/ibd/2010/C2-Anexx.pdf (accessed on 13/06/2014).
167 Razak and Lautt, *Islamic Financial System Principles and Operations*, 765.

parties to use such method instead of court's litigation and award is also not binding on the court.[168]

Nowadays Islamic finance is recognized internationally, so to avoid the uncertainty of the jurisdiction of foreign courts the parties prefer to resolve disputes through alternate dispute resolution.[169] There are many institutions established in many countries to settle disputes in Islamic finance but they also deal with other industries.

These institutions are:[170]

- Cairo Regional Centre for International Commercial Arbitration (CRCICA)[171]
- Kuala Lumpur Regional Centre for Arbitration (KLRCA)[172]
- Tehran Regional Arbitration Centre (TRAC)[173]
- Regional Centre for International Commercial Arbitration (RCICAL)[174]
- Bahrain Chamber of Dispute Resolution (BCDR)[175]
- Karachi Centre for Dispute Resolution (KCDR)[176]

However, there are few institutions that provide facility of arbitration and mediation in other regions for settlement of disputes. Below are few international institutions for arbitration and mediation:[177]

---

168 Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, 195-197.
169 Razak and Lautt, *Islamic Financial System Principles and Operations*, 765.
170 Ibid
171 http://crcica.org.eg/ (accessed June 10, 2014).
172 http://klrca.org/ (accessed June 10, 2014).
173 http://www.trac.ir/ (accessed June 10, 2014).
174 http://www.rcicalagos.org/intern_character.html (accessed June 10, 2014).
175 http://www.bcdr-aaa.org/ (accessed June 10, 2014).
176 http://www.kcdr.org/ (accessed June 04, 2014).
177 Razak and Lautt, *Islamic Financial System Principles and Operations*, 765.

- International Islamic Mediation & Arbitration Centre (IMAC)[178]
- Dubai International Arbitration Centre (DIAC)[179]
- Hong Kong International Arbitration Centre (HKIAC)[180]
- Singapore International Arbitration Centre (SIAC)[181]

In 1978, Kuala Lumpur Regional Centre for Arbitration (KLRCA) was established in Malaysia to settle disputes in Islamic financial transactions. The Kingdom of Bahrain launched the Bahrain Chamber of Dispute Resolution (BCDR) in 2010 with the participation of American Arbitration Association[182]. In Pakistan there is no formal institution which provides the service of alternate dispute resolution to the Islamic financial sector,[183] all banking cases are dealt by banking courts of Pakistan according to the establishment of banking courts under section 5 of The Financial Institution (Recovery of Finances) Ordinance, 2001.[184] Recently, in Pakistan significant development has been made relating to ADR. In 2005 a mediation center, in collaboration with the International Finance Corporation of World Bank (IFC) has been established at Karachi, which is known as Karachi Centre for Dispute Resolution (KCDR).[185] They provide mediation in commercial disputes i.e. rent disputes, corporate disputes and the disputes between banks and clients etc.[186]

---

178 http://www.arabcci.org/IMAC_aboutus.htm (accessed June 10, 2014).

179 http://www.diac.ae/idias/ (accessed June 10, 2014).

180 http://www.hkiac.org/en/ (accessed June 10, 2014).

181 http://www.siac.org.sg/ (accessed June 10, 2014).

182 Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, 196.

183 Sajid Zahid, *Guide To Dispute Resolution in Middle East* (Dubai: Herbert Smith LLP, 2010/2011), 68. url: http://www.scribd.com/doc/108965903/Guide-to-Dispute-Resolution-in-the-Middle-East.

184 Ordinance No. XLVI OF 2001.

185 Sajid Zahid, *Guide To Dispute Resolution in Middle East* (Dubai: Herbert Smith LLP, 2010/2011), 70.

186 http://www.kcdr.org/cases.php (accessed June 04, 2014).

Arbitration is a method to resolve dispute without intervention of court and it is also in accordance with the *Shariah*. The resolution of dispute through reconciliation and mediation is also mentioned in *Quranic* verse as follows:

"If two parties among the believers fall into quarrel, make ye peace between them".[187]

There were few cases relating to Islamic banking that had been referred by the parties to English courts due to the choice of law in the contracts. One of these cases was *Islamic Investment Company of the Gulf (Bahamas) Ltd (IICG) v Symphony Gems N.V & Ors*[188] . In this case the agreement between IICG and Symphony did not fulfill the pre-requisites of *murabahah* contract, while the court, found the contract as valid and enforceable under the English law and gave judgment in favour of IICG against Symphony. In another case, *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC*[189] the English High Court gave summary judgment in favour of the claimant (Shamil Bank of EC) against the defendants (Beximco Company group and their guarantor) in respect of the monies, where by the total judgment awarded was some USD 49.5 million.

Hence, both the cases *IICG v Symphony* and *Shamil Bank v Beximco* had faced the same problem i.e. while determining Islamic banking transaction, English courts preferred to follow common law because of common law system prevailing in England. And it was not expected to apply *Shariah* principles in English courts. Moreover, in both cases the fault was on the part of the parties due to wrong choice of jurisdiction.

[187] Quran, 49: 9-10.
[188] 2002 WL 346969 (Q.B. Comm. Ct. Feb. 13, 2002).
[189] [2004] EWCA Civ 19 (Court of Appeal, Civil Division): [2004] All ER (D) 280 (Jan).

It is clear that none of three countries (Malaysia, Bahrain and Pakistan) have any formal institute or forum that resolves Islamic banking disputes. Therefore, it is recommended that to resolve disputes between the parties in Islamic banking transactions, the matter must be resolved through alternate dispute resolution. The tribunal third party, negotiator, arbitrator or mediator, who has knowledge of Islamic banking transactions and *Shariah*, can better settle disputes between the parties.

In the final analysis, it is clear that Malaysia has well defined legal framework for Islamic financial industry. In comparison with Pakistan and Bahrain, they do not have any unique and separate legislation for Islamic banks. In Pakistan, Islamic financial industry is functioning under conventional banking law and only circulars issued by the State Bank of Pakistan. So, it is necessary in Pakistan and Bahrain to take legislative steps for Islamic financial industry.

Furthermore, the fundamental philosophy of Islamic banking business is prohibition of interest which is different from conventional banking system. Therefore, at present there is a dire need for a separate and unique legal framework for Islamic banks in Pakistan. It can facilitate the smooth functioning of Islamic banking industry. It is clear that countries having a proper and effective legal framework can better regulate Islamic banks and such countries are more prosperous and can also grow more quickly as compared to those countries that lack it.

CHAPTER 4

REGULATION AND SUPERVISION OF ISLAMIC BANKS IN DIFFERENT COUNTRIES

4.1 Introduction

Islamic banks as well as conventional banks need a central bank for regulation and supervision of the financial system of the country. Bank deals to the general public and their fund deposits. The bank receives deposits from the customers that are much more than the bank's leverage and its capital. It is, therefore, inevitable for the banks to protect its customers from mismanagement, fraud, insider trading, market manipulation, credit consideration and over-lending. It is also important that the banks should provide financial stability and to protect the money market and capital market. Therefore, the prudential regulatory and supervisory framework is necessary for banking sector as compared to non-banking corporations.[190]

4.2 The Global Regulatory and Supervisory Systems

The functions of Islamic banks, investment banks, conventional banks, mutual funds and insurance companies are different from each other. To protect the financial,

[190] Chapra and Khan, *Regulation and Supervision of Islamic Banks*, 17.

banking and non-banking institutions, each sector is regulated and supervised by a superior authority such as central bank, securities commission etc. With the passage of time there is an increase in financial conglomerates and this makes the financial environment more complex. Some of the conglomerates are:[191]

i. There are acquisitions and mergers between banks, securities firms and insurance companies.

ii. Insurance companies and banks acquire fund managers.

iii. Non-financial corporations involved in the financial activities.

iv. Banks setting up insurance companies and insurance companies involve in the banking activities.

The important steps taken place in regulation and supervision of financial institutions are:[192]

i. At the national level, the central banks of the countries are responsible for regulation and supervision of Islamic and Conventional banks such as Pakistan has introduced the State Bank of Pakistan (SBP) and Bahrain has introduced the Central Bank of Bahrain (CBB).

ii. Some international regulatory institutions are introduced at international level such as the Basel Committee for Banking Supervision (BCBS), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Rating Agency (IIRA), Islamic Financial Service Board (IFSB), International Islamic Financial Market (IIFM),

---

[191] Ibid 18-19.
[192] Ibid 20-21.

International Islamic Liquidity Management Corporation (IILM) and Islamic *Fiqh* Academy (IFA).

iii. The Basel committee on banking supervision provides a complete framework for regulation and supervision of banks.

4.3 The Nature and Goals of the Regulators

After understanding the meaning of global regulatory and supervisory systems of regulation of financial institutions, it is important to know that what the major objectives of regulators are? In most of the countries the central banks are the regulators of Islamic banks and conventional banks. The major goals of the central banks or the regulators are as following:

a) Protection from bank's failure[193]

The main goal of central banks is the prevention of bank's failure. The ultimate goal of banks supervision and regulation is to protect the investors from the bank's failure.

b) Price stability[194]

The second important goal of the regulator or central bank is to provide money stability. It helps to maintain a low rate of inflation.

c) Financial stability[195]

The third objective of the regulator of Islamic banks and conventional banks is financial stability. It helps to protect from financial crises. It provides the investors a

[193]Archie K. Davis, "Banking Regulation Today: A Banker's View Source: Law and Contemporary Problems", *Duke University School of Law Stable* 31, no.4 (autumn, 1966):639-647, accessed August 15, 2014, url: http://www.jstor.org/stable/1190828.

[194] Razak and Lautt, *Islamic Financial System Principles and Operations*, 744.

[195] Ibid.

smooth, efficient and transparent financial system.

d) To provide a stable economy[196]

The fourth objective of the regulator is to provide a stable economy. It means that high and maintainable economic growth.

e) Sound banking operations[197]

The regulators provide sound and safe banking activities. The regulator of banks in the country implements and enforces the relevant laws through which banks can conduct its functions and operations. It also highlights the punishments in case of banks failure to comply the laws and regulations mentioned by the regulator of Islamic banking and finance.

4.4 Regulation and Supervision of Islamic Banks

The central banks of the most of the countries are responsible for supervision and regulation of Islamic financial institutions. The central bank is responsible for prevention of bank's failure, financial and price stability and to provide a stable economy. The difference between conventional banking system and Islamic banking system does not make any difference in terms of regulation and supervision. Both sectors need a proper regulation for their growth and development. The concept of regulation and supervision of Islamic banks is not new. In March 1981, the member states of Organization of Islamic Conference (OIC) approved report on "Promotion, Regulation and Supervision of Islamic Banks."[198]

---

[196] Ibid.

[197] Archie K. Davis, "Banking Regulation Today: A Banker's View Source: Law and Contemporary Problems", 639-647.

[198] Chapra and Khan, *Regulation and Supervision of Islamic Banks*, 23.

Like conventional financial institutions, Islamic banking institutions also need prudential regulation and supervision. The rationale for the regulation of Islamic banking institution is as following:[199]

Firstly, if Islamic banks are poorly regulated, primarily, it may affect its shareholders who make investments in banking business. The failure of the banking system not only affects the shareholders and the corporation but it may affect the whole economy and financial system of the state. It can destabilize the whole economic and financial system of the state and also affect the depositor's confidence. And the depositors may withdraw their deposits.

Secondly, regulatory authorities must establish a mechanism through which they can ensure that whether Islamic financial institutions are in compliance to the principles of *Shariah* or not.

Thirdly, in Islamic banks, there are the interest of investment depositors[200] and demand depositors.[201] Regulation of Islamic banking and finance is necessary for protection of the interest of depositors and investment account holders (IAHs). But in most of the countries, the regulators do not distinguish between the investment account holders and depositors. The Islamic financial institutions give guarantee to return capital to current account holders and IFIs are responsible for all losses. While

---

[199] Ibid.

[200] Investments Deposits that share in the return of investment operation in proportion to the amount of deposit and on the basis of distributing the net return on a contractual ratio. Islamic banks usually differentiated between long and short run investment deposits through this profit sharing ratio by offering higher ratio to deposits committed for longer periods. These profits are not in fact liabilities on the Islamic banks; they are rather investments with it.

[201] Demand Deposits which are guaranteed and represent liabilities, and they do not earn any return.

in IAHs are not capital guaranteed, they bear the risk of loss. But mostly IAHs are not aware the risk of loss. Therefore, IAHs need prudential regulations.[202]

4.5 International Standard-Setting Organizations for Islamic Banking & Finance

It is evident from the above discussion that the Islamic financial institutions need proper, efficient and effective regulation. Therefore, International standard-setting organizations issue standards for regulation and supervision of Islamic banking and financial industry. Those international Islamic financial institutions, which set the international regulatory standards for Islamic financial industry are not formal in nature and also such standards, do not have a legal force. They establish the best regulatory standards for Islamic finance and countries implement those standards through legislations or management.[203] The details of these institutions are as following:

4.5.1 Basel Committee for Banking Supervision (BCBS)

The Basel Committee for Banking Supervision was established in 1974 by the ten central bank's Governors. It provides a forum for matters relating to banking regulation and supervision. The aim of BCBS is to improve the supervision of banking and also understand the supervisory banking issues. It provides international standards on the Concordant on cross border banking supervision, capital adequacy and of

[202] Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, "Diversity in the regulation of Islamic Financial Institution", *The Quarterly Review of Economics and Finance 46* (2007):790.
[203] Razak and Lautt, *Islamic Financial System Principles and Operations*, 664.

effective banking supervision. After world financial crises in 2007-2009, the membership of BCBS has been extended from G-10 to G-20.[204]

4.5.2 Islamic Financial Services Board (IFSB)

Islamic Financial Services Board (IFSB) was established on 3 November, 2002 and officially started its operations on 10 March, 2003.[205] It is based in Malaysia. As by April 2014, it has 184 members including 59 supervisory and regulating authorities, 111 professional firms and financial institutions and 8 international inter-governmental organizations.[206]

The purpose of establishment of IFSB is to set the universal supervisory and regulatory standards for Islamic banks, insurance companies and capital market. IFSB completes the work of the International Organization of Securities Commission (IOSCO) and Basel Committee for Banking Supervision (BCBS). The standards issued by IFSB are very important in Islamic financial industry. Firstly the adoption of such standards would help to harmonize the supervisory and regulatory framework of Islamic banking and finance. Secondly, the adoption of uniform international regulatory and supervisory standards helps to grow Islamic financial industry parallel to conventional financial industry.[207]

The IFSB has issued 22 standards, Technical Note and Guiding Rules for the Islamic Financial industry. It finalized standards on the risk management, corporate governance, supervisory review process, governance for Islamic Insurance operations, *Shariah* governance system, capital adequacy framework for Islamic banking and

---

[204] Ibid, 665.
[205] Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, Diversity in the regulation of Islamic Financial Institution, 788.
[206] http://www.ifsb.org/background.php (accessed Sep. 11, 2014).
[207] Razak and Lautt, *Islamic Financial System Principles and Operations,* 666.

financial institutions etc.[208] The central banks of the countries can provide consistent and effective oversight through adoption of these regulatory standards.[209]

4.5.3 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Accounting and Auditing Organization for Islamic Financial Institutions was established on 26th February, 1990 and since then, it is developing the accounting, auditing, *Shariah* and governance standards for Islamic financial institutions.[210] In 1993, AAOIFI introduced first time standards for Islamic financial institutions. It was registered in kingdom of Bahrain. The founding members of AAOIFI were Al Baraka Banking Group (Bahrain), Bukhari Capital (Malaysia), Islamic Development Bank and Al Rajhi Banking and Investment Corporation (Saudi Arabia), Kuwait Finance House (Kuwait) and Dar Al Mal Al Islami (Switzerland).[211]

The purposes of the AAOIFI are:[212]

i) International standards relating to the development of governance, accounting and auditing standards for Islamic Financial Institutions.

ii) To prepare, publish and explain the accounting and auditing standards.

iii) To amend and review international standards relating to accounting and auditing.

iv) To develop accounting, auditing and governance standards through seminars, periodicals, newspapers, training and commission of research.

---

[208] http://www.ifsb.org/background.php (accessed 11/09/2014).

[209] Kelly Holden," Islamic Finance: Legal Hypocrisy", *International Law Journal* 25, no.341 (2008):365.

[210] http://www.aaoifi.com/en/about-aaoifi/our-history.html (accessed Sep. 11, 2014).

[211] Razak and Lautt, *Islamic Financial System Principles and Operations*, 669.

[212] Ibid.

AAOIFI is supported by Islamic financial institutions and central banks and its standards are adopted in Saudi Arabia, Pakistan, Bahrain, Malaysia, Qatar, Sudan, Australia, South Africa, Jordan and Syria.[213]

4.5.4 International Islamic Rating Agency (IIRA)

The major concern of conventional financial rating system is financial and economic strength of counter parties. The conventional financial rating system fully ignores the principles laid down by the *Shariah.* The IFIs always need for an Islamic rating agency that must be independent from conventional financial rating system. In October, 2002 the International Islamic Rating Agency (IIRA) was established in kingdom of Bahrain and in July 2005 it started its operation formally. The shareholders of IIRA include two multilateral financial institutions, three rating agencies, seventeen insurance companies, banks and others.[214] The purpose of IIRA is to give an independent valuation of compliance to the Islamic financial institutions in accordance with *Shariah,*[215] provide a separate rating system to Islamic financial institutions and also development and establishment of *sukuk* market. It provides rating in accordance with principles of the *Shariah.*[216]

4.5.5 International Islamic Financial Market (IIFM)

International Islamic Financial Market is based in Bahrain and was incorporated in 2001. The Islamic Development Bank, the Central Bank of Sudan,

[213]Kelly Holden, "Islamic Finance: Legal Hypocrisy", *International Law Journal* 25, no.341 (2008): 365.

[214]http://www.iirating.com/Shareholder.aspx (accessed Sep. 13, 2014).

[215]Munawar Iqbal, "International Islamic Financial Institutions", in *Handbook of Islamic Banking,* ed. M. Kabir Hassan and Mervyn K. Lewis (Cheltenham: Edward Elgar Publishing Limited, 2007), 380.

[216]Obiyathulla Ismath Bacha and Abbas Mirakhor , *Islamic Capital Markets: A Comparative Approach* (Singapore: John Wiley & Sons, 2013), 78, url: http://eu.wiley.com/WileyCDA/WileyTitle/productCd-1118465148.html.

Indonesia and Bahrain, Malaysian regulatory authority and ministry of finance of Brunei are the founding members of IIFM.[217] The purpose of IIFM is the establishment, promotion, development and self- regulation of Islamic money market and capital market. It helps in standardization and promotion of Islamic financial instruments,[218] products and contracts. It also gives recommendations for growth and development of money.[219]

The objects and purposes of IIFM are:[220]

i) To provide a system of Islamic hedging.[221]

ii) To provide a framework for Islamic instruments such as *sukuk.*

iii) To provide regulations for primary and secondary market.

iv) To improve the present framework of Islamic banking and finance.

4.5.6 International Islamic Liquidity Management Corporation (IILM)

The International Islamic Liquidity Management Corporation was established in Kuala Lumpur on 25 October, 2010. Two multilateral organizations and central banks were the founding members of IILM. Presently, the members of IILM are from the monetary agency and central banks of Indonesia, Malaysia, Kuwait, Mauritius,

[217]Volker Niehaus, "Islamic Economics in Practice Interest Free Financial Management", in *Islam in the World Today: A Handbook of Politics, Religion, Culture and Society*, ed. Werner Ende and Udo Steinbach (New York: Cornell University Press, 2010), 157.

[218] Such as Sukuk.

[219] Razak and Lautt, *Islamic Financial System Principles and Operations*, 670.

[220] Ibid.

[221] In the Arabic language, the term hedging is known as *tahawwut* which origins from the word *hata.* The linguistic meaning of the word *hiyatah* includes precaution, protection, attention and patronage. The technical meaning of the word *tahawwut* in the field of finance is: the adoption of processes and arrangements and the selection of contractual formats that guarantee the reduction of risks to a minimum while maintaining good possibilities for return on investment.

Nigeria, Qatar, Luxembourg, Turkey, the United Arab Emirates and the Islamic Development Bank.[222]

The objective of IILM is "to facilitate cross-border liquidity management among institutions offering Islamic financial services by making available a variety of *Shariah*-compliant instruments, on commercial terms, to suit the varying liquidity needs of these institutions. The IILM seeks to foster regional and international co-operation to build a robust liquidity management infrastructure at national, regional and international levels."[223]

The International Islamic Liquidity Management Corporation has also published "The IILM Act, 2011". It contains 10 sections and 6 schedules.[224]

4.5.7 Islamic *Fiqh* Academy (IFA)

The Islamic *Fiqh* Academy (IFA) was established in Saudi Arabia in 1981. The Organization of Islamic Conference (OIC) is also associated with Islamic *Fiqh* Academy. The head office of IFA is in Jeddah, Saudi Arabia. The OIC has 57 member states and 43 of such states are associated with IFA. The scholars of the IFA are appointed by the member states. It is not possible for a single *Shariah* scholar to have knowledge of all matters, so, it provides a collective *ijtihad*[225] institution to the *Shariah* scholars. The *Shariah* scholars from different member states collectively analyses the issues and solve it in accordance with Islamic principles. It is followed around the world and it gives a lot of benefits to the Muslim states. Generally, it helps

---

[222] http://www.iilm.com/about-iilm/about-us.html (accessed Sep. 11, 2014).
[223] http://www.iilm.com/about-iilm/our-objectives.html (accessed Sep. 11, 2014).
[224] http://www.iilm.com/publications/iilm-act html (accessed Sep. 11, 2014).
[225] The term 'Collective Ijtihad' is derived from two words: ijtihad and jama'i. Collective ijtihad is defined by Al-'Attar as "as the consensus of more than one mujtahid on a certain Shari'ah rule, into which all had put their efforts to derive the ruling from the relevant sources."

to harmonize the laws and regulations but it is particularly, beneficial to Islamic banking and finance.[226]

The above discussion shows that international standard setting organizations set many regulatory standards for Islamic financial institutions. The industry can grow more successfully by incorporation of such regulatory standards into present regulatory framework of Islamic banks of the country.

4.6 Regulation and Supervision of Islamic Banks in Different Countries: Case Study of Pakistan, Malaysia and Bahrain

Prudential regulation, supervision, enforcement and monitoring arrangements for Islamic banking and financial sector are as important as rest of the financial system of the country. The only distinction between Islamic and conventional financial system is that Islamic finance institutional arrangement is derived from Islamic financial markets, Islamic banking laws, Islamic financial instruments and the Islamic financial infrastructure.

This part of research is based on the cross country comparison of three Muslim countries namely Pakistan, Malaysia and Bahrain on the basis of regulatory framework of Islamic banks in these countries.

4.6.1 Regulation and Supervision of Islamic Banks in Pakistan

4.6.1.1 Central Bank / Regulator of Financial Institutions

Before the independence, Central Bank of India (Reserve Bank of India) was the regulator of financial institutions in the Sub-Continent. After the independence, on

[226] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, 198-199.

14th August, 1947, the British Government distributed the bank's reserve between Pakistan and India.[227] After that the government of Pakistan established the State Bank of Pakistan in 1948. On 1st July, 1948, the State Bank started its operation in Pakistan. The head office of the SBP is in Karachi.[228] It grants license to the banks and also has an authority to cancel any license.[229] The State Bank of Pakistan (SBP) is the Central Bank of Pakistan and regulator of financial institutions. It also regulates and supervises the Islamic banking institutions of Pakistan through its *Shariah* Board.[230]

For development of Islamic banking and financial industry, the SBP is following three-pronged strategy. The three-pronged strategy of the State Bank of Pakistan is as following:[231]

1. Islamic Banking through Subsidiaries

The State Bank of Pakistan allows banks to form subsidiaries for Islamic banks under part I of the strategy. These subsidiaries should perform their functions strictly in conformity with the principles of *Shariah*. The State Bank of Pakistan has issued a detail criterion for setting up of subsidiaries by banks.

2. Islamic Banking through Stand-alone Branches

The part II of the strategy explains that the existing commercial banks may open stand-alone Islamic banking branches. The commercial bank must obtain license

---

[227] British Government distributed the Central Bank of India's reserve between Pakistan and India with the proportion of 30% and 70% respectively.

[228] http://www.sbp.org.pk/sbp_bsc/Manag-Dir-Jan-11.pdf (accessed Oct. 05, 2014).

[229] *State Bank of Pakistan v. Franklin Credit and Investment Company Ltd* (2010 SCMR 121 Supreme Court).

[230] Chapra and Khan, *Regulation and Supervision of Islamic Banks*, 28

[231] http://www.sbp.org.pk/bpd/2003/C1.htm (accessed Sep. 05, 2014).

from regulatory authority and the bank is also required to set-up Islamic Banking Division and *Shariah* advisors for its stand-alone branches.

3. Islamic banking through Complete Commercial Banks

For part III of the strategy, in December, 2001 the State Bank of Pakistan has issued detail requirements for setting up of complete Islamic commercial bank. Al-Meezan Investment Bank is the first full-fledge Islamic bank of Pakistan.

4.6.1.2 Roles and Functions of the State Bank of Pakistan

The core roles and functions of the State Bank of Pakistan are:[232]

i) Ensuring the soundness of financial and economic system of Pakistan.

ii) Supervision and regulation of conventional and Islamic financial institutions and also to protect the interest of the customers. It also helps the customers to provide a fair, efficient and transparent financial market.

iii) To help the economic growth and maintain financial stability.

iv) Management of exchange rate and balance of payment.

4.6.1.3 Regulatory Framework of Islamic Banks in Pakistan

Islamic banking and finance is in its nascent stage, therefore, in Pakistan particular Islamic banking regulatory framework does not exist. Work is in progress to introduce a separate prudential regulatory framework for Islamic banking and finance.[233] The State Bank of Pakistan has issued some regulatory requirements relating to Islamic banks such as fit and proper criterion for *Shariah* Advisors, licensing requirements for establishment of full-fledge Islamic banks, stand-alone

---

[232] http://www.sbp.org.pk/about/core_functions/index.htm (accessed June 07, 2014).

[233] Ishrat Husain, Islamic Finance, Prudential Arrangements for Stability and development of Islamic finance

branches and subsidiaries of Islamic banks etc. The regulatory laws relating to Islamic banking and finance in Pakistan are as following:

a) The State Bank of Pakistan Act, 1956[234]

The State Bank of Pakistan Act, 1956 is divided into five chapters. It broadly deals with the establishment, incorporation and share capital of the bank, functions and responsibilities of directors, governors, deputy governor and functions of the State Bank of Pakistan. The business and functions of SBP are mentioned from section 17-40. There are following functions of SBP:[235]

i. Issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct monetary policy.

ii. Including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions.

iii. State Bank also develop the financial framework, institutionalization of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors.

b) Circulars issued by Islamic Banking Department of the State Bank of Pakistan

The Islamic Banking Department (IBD) of the State Bank of Pakistan (SBP) issue Circulars for financial industry. The important Circulars issued by the State Bank of Pakistan related to regulation of Islamic banks are as following.

---

[234] http://www.sbp.org.pk/about/sbpact/SBP_ACT_1956.pdf (accessed Nov. 28, 2014).
[235] Ibid.

i. Minimum *Shariah* Regulatory Standards[236]

The State Bank of Pakistan has issued 'Minimum *Shariah* Regulatory Standards for Islamic Banks'.[237] It provides only a detail criterion for opening of schedule Islamic commercial banks, setting up of Islamic banking subsidiaries, stand-alone branches and conversion of conventional banking branches into Islamic banking branches.[238]

Presently, in Pakistan there is presence of five schedule Islamic commercial banks and fourteen stand-alone Islamic banking branches of conventional banks. The SBP has been granted license to Muslim Commercial Bank (MCB) to establish Islamic banking subsidiary in Pakistan. The MCB will be the first Islamic banking subsidiary in Pakistan with the name of 'MCB Islamic Bank Ltd'.[239] On Oct. 20, 2014 Meezan Bank has acquired the operations of HongKong Shanghai Banking Corporation (HSBC).[240] HSBC has 10 branches in Pakistan and the State Bank of Pakistan as the regulator of Islamic banking industry directs the Meezan Bank to convert operations of HSBC into Islamic bank.[241]

The State Bank of Pakistan has provided a procedure of conversion of conventional banking branches into Islamic banking branches.[242] However, it does not explain the proper mechanism or methodology through which a conventional bank converts its existing assets and liabilities into Islamic bank. This is very important regulatory issue in Pakistan and Meezan Bank will face this problem at the time of conversion of HSBC assets and liabilities into Islamic banking assets and liabilities.

---

236 http://www.sbp.org.pk/ibd/2004/cir02.htm (accessed Nov. 28, 2014).

237 The detail of licensing requirements of Islamic banks in Pakistan are mention on Pg. 60.

238 http://www.sbp.org.pk/ibd/2010/C2.htm (accessed Nov. 28, 2014).

239 Islamic Banking Bulletin June 2014, Islamic Banking Department State Bank of Pakistan, (accessed Nov. 28, 2014), http://www.sbp.org.pk/ibd/bulletin/2014/IBB-Jun-2014.pdf.

240 http://meezanbank com/HSBCpakistan.aspx (accessed Nov. 29,2014).

241 Ibid.

242 http://www.sbp.org.pk/ibd/2004/cir02.htm (accessed March 10, 2014).

Therefore, it is suggested that the SBP must adopt the Accounting and Auditing Organization of Islamic Financial Institutions *Shariah* Standard No. 6 that deals with the 'Conversion of a Conventional Bank into Islamic Bank'.[243] This standard explains the criteria, mechanism and procedure that are required by a conventional bank to convert into Islamic bank. This standard explains the procedure of conversion of existing assets and liabilities of conventional bank into Islamic bank. It provides guidance on how to treat the liabilities and receivables of the bank prior to the conversion, whether or not such liabilities or receivables are paid or received. It also provides a detail mechanism of a treatment of prohibited assets that are in the possession of conventional bank. The important requirements of this *Shariah* Standard are as following:

i. It requires that all *Shariah* requirements be executed in the process of converting a conventional bank to an Islamic bank. It also requires that all transactions should be incompliance to *Shariah* after conversion.

ii. In providing Islamic banking services, it is not permissible for the bank to receive interest in any form and all interest based transactions must cease to be used after conversion. It also requires that Islamic bank should convert its operations towards *murabahah* to the purchase orderer, *mudarabah, ijarah* etc.

iii. All possible efforts must be exerted to terminate all interest based loans whether such loans are long-term or medium-term that the conventional bank has made before conversion.

[243]http://aaoifi.com/en/standards-and-definitions/shari%E2%80%99a (accessed Nov. 28, 2014).

iv. If a bank has possession of prohibited non-monetary assets or tangible assets, the bank must destroy them. And if the bank is entitled to receive consideration for supplying non-permissible assets or services, the bank receive such consideration with the intention to donate it in charity.

v. All impermissible earning of conventional bank acquired by Islamic bank after conversion needs to be disposed of as early as possible.

These are some important requirements which are mentioned under AAOIFI *Shariah* Standard No. 6.

Another issue faced by Islamic banks is the lack of law explaining the mechanism of swapping over of a customer from Islamic banking system to conventional banking system or conventional banking system to Islamic banking system, Such as, when HSBC customers swap over to Islamic banking system, what mechanism should be adopted by the Meezan Bank to shift the customer's rights and liabilities from conventional banking system to Islamic banking system. Practically, in Pakistan, in such kind of situation if a customer take running finance from conventional bank and when he shifts to Islamic bank; it's simply converted into *murabahah* financing. However, such kinds of transactions are not so simple. Banks can use any method of conversion because of absence of proper mechanism; therefore, there is a need that the State Bank of Pakistan should specify rules for such type of customers.

ii. Risk Management Guidelines for Islamic Banking Institutions[244]

Islamic Banking Department of State Bank of Pakistan has issued Circular No. 01 in 2008, which deals with Risk Management and it is based on the standards issued by Islamic Financial Services Board (IFSB). The bank needs to identify, manage, control and mitigate the risk associated with business. Risk management guidelines include the following categories:

a) Credit Risk

Credit risk is generally defined as the potential that counterparty fails to meet its obligations in accordance with the agreed terms. Such as counterparty defaults in payment to the bank or in case of *salam* contract the person fails to deliver goods.

b) Equity Investment Risk

The equity investment risk deals with the investments made by a customer in *mudarabah* or *musharakah.*

c) Market Risk

Market risk is defined as "the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leasable assets (including *sukuk)* and in off-balance sheet individual portfolios The risk relates to the current and future volatility of market values of specific assets (for example, the commodity price of a Salam asset, the market value of a *sukuk*, the market value of *murabahah* assets purchased to be delivered over a specific period) and of foreign exchange rates."

---

[244] http://www.sbp.org.pk/ibd/2008/Annex-c1.pdf (accessed Sep. 08, 2014).

d) Liquidity Risk

The liquidity risk is the potential loss to Islamic banking institutions arising from the inability either to meet their obligations or fail to increase funds in assets as they fall due without incurring unacceptable costs or losses.

e) Rate of Return Risk

In Islamic banking system the return on principle amount is not fixed and predetermined but variable. Islamic banks accept deposits through *mudarabah* and *musharakah* mechanism. Profit of depositor in Islamic banks depends on the outcome of investment made by the bank.

The rate of return means that the ration of return to the customer by the financial institution. Islamic banking institutions exposed to the rate of return risk in the context that the investment account holders having expectation of a higher rate of return due to increase in benchmark rate. Rate of return risk differ from internal rate risk.

f) Operational Risk

The operational risk means that when the Islamic financial institution face risk due to the failure in their internal control.

iii. Instructions and Guidelines for *Shariah* Compliance in Islamic Banking Institutions[245]

Islamic Banking Department of the State Bank of Pakistan has issued Circular No. 02 in 2008, which deals with 'Instructions and Guidelines for *Shariah* Compliance in Islamic Banking Institutions'. It explains the procedure of appointment

[245] http://www.sbp.org.pk/ibd/2008/C2.htm (accessed 08 Sep., 2014).

of *Shariah* advisors of Islamic banks and also explains the permissible Islamic modes of finance such as *mudarabah, musharakah, salam, ijarah, istisna, wakalah, kafalah, murabahah, musawamah and tawarrur.*

c) Adoption of International Standards for Islamic Banks

The international standard setting organizations set standards for Islamic banking and finance. Pakistan has adopted AAOIFI and Basel capital requirement and supervisory standards. Pakistan has adopted the following regulatory standards for Islamic banks.[246]

i) Adoption of AAOIFI *Shariah* Standards

The SBP has adopted five AAOIFI *Shariah* standards. The Islamic Banking Department (IBD) of the SBP invites comments on *Shariah* Standards from *Shariah* Advisors of all Islamic banks. These comments are consolidated and then analysed by the IBD of the SBP. After approval of *Shariah* Board such standards implemented on Islamic banking institutions. Islamic banking industry of Pakistan has adopted following five AAOIFI *Shariah* standards.[247]

a) *Shariah* Standard No. 03 (Default in Payment by a Debtor)[248]

This *Shariah* standard provides a mechanism of sale of pledged asset for liquidation of debt. The creditor is entitled to apply for the sale of any asset pledged as collateral for the debt, for the liquidation of the debt. He is equally

[246] Ahcene Lahsasna and M. Kabir Hassan, "The Shariah Process in Product, Development and Approval in ICM", in *Islamic Capital Market: Products and Strategies*, ed. Kabir Hasan and Micheal Mahlknecht (United Kingdom: John Wiley and Sons Ltd), 34
[247] http://www.sbp.org.pk/ibd/2010/C1-Appendix.pdf (accessed 05 Jan., 2015).
[248] Ibid.

entitled to stipulate that the debtor must give a mandate to the creditor to sell the pledged asset without intervention of the courts.

b) *Shariah* Standard No. 08 (*Murabahah* to the Purchase Orderer)[249]

Following are essential features of *murabahah* to the purchase orderer:

i. The most important condition in *murabaha*h to the purchase orderer is that the transaction between customer (purchase orderer) and original supplier must genuine and not fictitious. And it is also essential to exclude any prior contractual relationship between the customer and original supplier of the item ordered.

ii. It is not permissible that the document of promise to buy should include a bilateral promise which is binding on both parties.

iii. The important condition of *murabahah* transaction is that the bank should itself purchase the product from supplier. However, the institution may appoint agent on behalf of institution. The customer should not act as an agent of the institution except in a situation of dire need. However, in this case it is also required that the institution must first acquire title of the item and then sell it to agent (purchase orderer/customer).

iv. There are two conditions which should be fulfilled by the customer, when a customer is authorized to purchase an item as the institution's agent. (a) The payment of item must pay by the institution (b) the institution should obtain from the supplier the document that confirms that a sale has taken place.

---

249 Ibid.

c) ***Shariah* Standard No. 08 (*Ijarah* and *Ijarah Muntahia Bittamleek*)**[250]

Ijarah is a type of contract in Islamic finance. Islamic financial institutions use *ijarah* contracts either as a lessor or a lessee. "*Ijarah* as ownership of the right to the benefit of using an asset for a period in return for a consideration." While, "*ijarah muntahia bitamleek* is a lease whereby the bank will buy and lease out equipment required by the customer for an agreed rental fee." However, it differs from Ijarah in the sense that *ijarah muntahia bitamleek* is an arrangement provides an option for the customer to acquire the ownership at the end of a specified period.

This mode of finance deals with the sale and lease back and it is permissible subject to the condition but it is not preferable.

It allows the contractual parties that they can terminate the *ijarah* contract before it begin to run with mutual consent of the parties. In *ijarah muntahia bitamleek* the method of transferring of title of the asset must be through a separate document.

d) Shariah Standard No. 12 (*Sharikat-ul-Milk* and Diminishing *Musharakah*)[251]

This Standard is applicable to all forms of joint ownerships. This Standard shall also be applicable to a diminishing *musharakah* based on *sharikat-ul-milk*. *Sharikat-ul-Milk* is defined as "It is a joint ownership of two or more persons in a particular asset or property without common intention to engage in business with respect to such asset or property."

---

[250] Ibid.
[251] Ibid.

Diminishing *Musharakah* (DM) is a form of joint ownership in asset or property in which any of the joint owners undertakes or promises to buy the ownership share of the other joint owner(s) gradually until the ownership of the joint asset or property is completely transferred to the purchasing joint owner.

e) **Shariah Standard No. 13 *(Mudarabah)*[252]**

In *mudarabah* contract, there are two parties, *mudarib* and *rabb-al-mal.* The customer acts as a *rabb-al-mal,* while bank acts as a *mudarib.* The profit is distributed according to the agreed ratio and typically it is 70% and 30% between the bank and the customer respectively. The parties of *mudarabah* contract may change the ratio of profit from time to time. In such mechanism customer bears all the loss whereas bank is not responsible for the loss

This standard was implemented without any amendments. It was eventually decided that the standard in its original form would be implemented in the country as it did not require any amendment or clarification

The regulatory framework in Pakistan is at par with international regulatory standards. The adaptation of AAOIFI *Shariah* Standards is a proof to the premise. The adoption of only five *Shariah* Standards out of 48 issued standards shows a relatively slow process. However, these adapted standards along with other guidelines including essentials of basic modes of financing and their model agreements issued by the central bank are minimum requirement to be followed by Islamic banking institutions while developing products. Banking institutions are also allowed to adopt any other

[252] Ibid.

AAOIFI *Shariah* Standards at their own discretion. This cause serious concern because of absence of the standardisation of *Shariah* rulings, the banking practices vary from bank to bank. And it affects the customer's confidence. The adoption of only five *Shariah* standards out of 48 is not enough. For the standardization and harmonization of Islamic banking *Shariah* rulings, there is a need of incorporation of such standards into our Islamic banking regulatory laws.

ii) Adoption of Basel Regulatory Standard for Islamic Banks[253]

A set of international banking regulations put forth by the Basel committee on banking supervision, which set out the minimum capital requirements of financial institutions with the goal of minimizing credit risk. Banks that operate internationally are required to maintain a minimum amount 8% of capital adequacy ratio.

A circular issued by Islamic Banking Department of SBP in 2004 that deals with 'Minimum *Shariah* Regulatory Standards'. This circular mentioned that all schedule Islamic commercial banks, subsidiaries by existing commercial bank and stand-alone branches for Islamic banking by existing banks should maintain minimum capital adequacy ratio of 8%.

In Pakistan, the international regulations for conventional banking such as Basel are applicable for Islamic banking as well. Basel issue standards for conventional banks and not for Islamic banking institutions. Therefore, there is a need to correlate the Basel requirements to Islamic banking and finance.

The regulators of financial institutions apply conventional banking standards on Islamic banking institutions as well. Islamic banking activities are different from

---

[253] http://www.sbp.org.pk/ibd/2009/CL2.htm (accessed 07 Dec. 2014).

conventional banking activities in several ways. Therefore, it is necessary that the Islamic banking industry should maintain minimum capital adequacy ratio according to their liabilities because Islamic banking transactions are more risky than conventional banking transactions. And also PLS assets of Islamic banks are un-collateralized; therefore, the minimum capital requirement for Islamic banks should be somewhat higher than Basel committee minimum level of 8%.

Keeping in view the above, it is clear that a complete regulatory framework of Islamic banks does not exist in Pakistan. In Pakistan Islamic banking sector is regulated through few directions issued by the State Bank of Pakistan and the adoption of few international regulatory standards. Therefore, it is suggested that the State Bank of Pakistan should frame a prudential regulatory framework for Islamic banking and finance and there is need of incorporation of international regulatory standards into present regulatory framework.

4.6.2 Regulation and Supervision of Islamic Banks in Malaysia

In contrast, Malaysia has developed a comprehensive setup for Islamic banks, *takaful* industry, Islamic money market and capital market. Malaysia is supporting the Islamic financial institutions through legal and regulatory framework which is based on the principles of *Shariah*, by *Shariah* experts and by the payment and settlement system.[254]

4.6.2.1 Central Bank/ Regulator of Financial Institutions

In Malaysia, the Bank Negara Malaysia (BNM) is the regulator of Islamic banking and financial institutions. It was established on 26 January, 1959 under the

[254] Razak and Lautt, *Islamic Financial System Principles and Operations*, 645.

Central Bank of Malaysia Act, 1958. On 25 November, 2009 the Central Bank of Malaysia Act 2009 (CBA 2009) was enacted and it repealed the Central Bank of Malaysia Act 1958. The Bank Negara Malaysia is fully owned by the Malaysian government.[255] It enforces the Banking and Financial Institutions Act 1989 (BAFIA), Islamic Banking Act 1983, Insurance Act 1996, Takaful Act 1984, Money Services Business Act 2011 (MSBA), Exchange Control Act 1953, Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLATFA), Development Financial Institutions Act 2002 (DFIA) and Payment Systems Act 2003 (PSA).

4.6.2.2 Roles and Functions of Bank Negara Malaysia

With the passage of time, due to growth and development in the Islamic banking and finance the roles and functions of central bank has expanded and evolved. Bank Negara Malaysia primarily focuses on economic stability, stability in monetary and payment system. It also focuses on the development of Islamic banking and finance. [256]

The major roles and functions of BNM mentioned in sec 5 of CBA 2009 are:[257]

1. For the growth and development of Malaysian economy, to promote financial and money stability.
2. To formulate monetary policy and conduct economic growth in Malaysia.
3. To keep reserve and issue currency.
4. To supervise and regulate financial institutions in Malaysia.

---

[255] http://www.bnm.gov.my/index.php?ch=en_about&pg=en_intro&ac=641&lang=en (accessed Sep. 09, 2014).

[256] http://www.bnm.gov.my/index.php?ch=en_about&pg=en_intro&ac=641&lang=en (accessed Sep. 15, 2014).

[257] http://www.bnm.gov.my/documents/act/cba2009_01.pdf (accessed Sep. 15, 2014).

5. To provide oversight over regulation of foreign exchange and money market.
6. To promote smooth and reliable operations of national payment and settlement system.
7. To promote efficient and transparent money market and capital market.
8. To act as a banker, financial agent and advisor of the government
9. To promote an exchange rate regime.

4.6.2.3 Regulatory Framework of Islamic Banks in Malaysia

The explanation of regulatory laws relating to Islamic banking and finance in Malaysia is given as under:

a) Central Bank of Malaysia Act, 2009[258]

The powers, functions and roles of BNM are mentioned in the Central Bank of Malaysia Act, 2009 (CBA 2009). This Act is further elaboration of the responsibilities of Central Bank of Malaysia. It is divided into 15 parts, 100 sections and 3 schedules. Section 28 of the Central Bank of Malaysia Act, 2009 confers the power of financial stability to the Central Bank of Malaysia. Section 30 of the Central Bank of Malaysia Act, 2009 states that the Central Bank in the interest of financial stability, may request any regulatory or supervisory authority to supervise any financial institution of Malaysia and provide all relevant information to the Central Bank. Section 31(1) also focuses on the financial stability and accordingly, the Central Bank also helps the financial institutions to mitigate the risk of loss. In addition the most important portion of this legislation is Part VII, which deals exclusively with Islamic banking business. Part VII is further divided into two chapters. Chapter 1 (Section 51 to 58) deals with

[258] http://www.bnm.gov.my/documents/act/cba2009_01.pdf (accessed Nov. 20, 2014).

the *Shariah* Advisory Council (SAC) and Chapter 2 (59 to 60) deals with the powers of the bank.

***i) Shariah* Advisory Council (SAC)**[259]

Central Bank of Malaysia Act 2009 from section 51 to 58 deals with the *Shariah* Advisory Council (SAC).

The BNM has established *Shariah* Advisory Council (SAC) under section 51. The SAC determine the Islamic principles for Islamic financial institutions. The council has a power to ascertain its own procedure to perform its duties and functions.

Section 52 explains the functions of SAC. The important functions are:

- To determine the law in accordance with the principles of *Shariah.*
- To act as an advisor and give advice to bank on *Shariah* matters.
- To act as an advisor to any person and Islamic financial institutions.
- To perform other relevant functions and duties.

Section 53 deals with the appointment of SAC members. Yang di-Pertuan Agong[260] shall appoint the members, who have knowledge and expertise in *Shariah*, banking, law and finance, on the advice of finance minister after consultation with BNM.

Section 55 deals with the consultation of Islamic financial institution and bank to *Shariah* Advisory Council. The banks or Islamic financial institution may at any time consult with SAC on any matter relating to Islamic transactions. The SAC shall

[259] Zulkifli Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK", *Kyoto Bulletin of Islamic Area Studies* 3, no.2 (March 2010):88.
[260] Yang di-Pertuan Agong is the head of Malaysian state according to the Constitution of Malaysia.

examine the relevant issue and advise the bank and Islamic financial institutions. The court and arbitrator can also consult with *Shariah* Advisory Council under section 56 of the said Act. The rules of *Shariah* Advisory Council shall be binding on court, arbitrators and Islamic financial institutions.

ii) Powers of the Bank

Central Bank of Malaysia Act, 2009 from section 59 to 60 deals with the powers of the bank.

The Central Bank may also issue circulars, notices and guidelines relating to Islamic financial matters which have a binding effect. Any person or institution fail to comply these will be liable for a fine under section 59 of CBA 2009. The Central Bank also helps the Islamic financial system as an international Islamic financial center under section 60.

b) Islamic Financial Service Act, 2013[261]

The Islamic Financial Service Act, 2013 is a new legislation in Malaysia, related to the regulation and supervision of Islamic financial institutions. The Malaysian regulatory infrastructure focuses on raising standards in risk management and governance. It also incorporates international regulatory standards with the regulatory and supervisory framework of Islamic banks in Malaysia. It maintains financial stability of Malaysian financial industry. The key features of the Act are as following:[262]

a) Greater transparency and accountability of the Bank in carrying out its principal object to safeguard financial stability.

---

[261] http://www.bnm.gov.my/documents/act/en_ifsa.pdf (accessed Nov. 11, 2014).
[262] Regulatory and Supervisory Framework 2012. 92

b) Specific provision which highlight Bank's role and responsibilities.

c) Differentiated intensity of regulation and supervision applied to institutions and markets under the Bank's purview, commensurate with the nature of activities and levels of risk posed by such institutions and markets to the overall financial system.

d) Transparent and assessment criteria for authorizing institutions to carry on regulated financial business, and for shareholder suitability.

e) Strengthened business conduct and consumer protection requirements to promote consumer confidence in the use of products and financial stability.

f) New provisions for the oversight of financial holding companies and non-regulated entities to take account of systemic risks that can emerge from the interaction between regulated and un-regulated institutions, markets and activities.

g) It clearly focuses on governance and *Shariah* Compliance in Islamic financial institutions.

c) Islamic Banking Act, 1983[263]

It was established on April 7, 1983. Under this Act Malaysia has taken legislative steps for licensing and regulation of Islamic banks and *Shariah* Advisors.

d) Adoption of International Standards for Islamic Banks

Malaysian Islamic banks follow international standards for Islamic banks such as International Accounting Standards, Basel capital requirements and core principles and CAMELS rating system.[264]

---

[263] http://www.bnm.gov.my/documents/act/en_ib_act.pdf (accessed Nov. 10, 2014).

This is an explanation of regulatory framework of financial institutions in Malaysia. From the above analysis it is clear that Malaysia has enacted some specific laws for regulation of Islamic financial institutions.

4.6.3 Regulation and Supervision of Islamic Banks in Bahrain

Bahrain is considered as a global leader of Islamic financial institutions in the Middle East. Currently, in the kingdom of Bahrain there are nineteen *takaful* companies and twenty six Islamic banks. In Bahrain, there is presence of dual banking system like Islamic banking system as well as conventional banking system.[265]

4.6.3.1 Central Bank/ Regulator of Financial Institutions

The Central Bank of Bahrain (previously known as Bahrain Monetary Agency) is the regulatory authority of financial institutions in the kingdom of Bahrain. It was established on 6 September, 2006[266] under the Central Bank of Bahrain and Financial Institutions Law, 2006. The Central Bank of Bahrain is responsible for supervision, regulation and licensing of Islamic banks, conventional banks, commercial banks, investment banks, capital market and insurance companies. The Bahrain Stock Exchange (BSE) is also regulated by the Central Bank of Bahrain.[267] The Central Bank of Bahrain also helps various institutions for regulation and development of Islamic finance including the General Council for Islamic Banks and Financial Institutions (GCIBFI), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Rating Agency (IIRA) and the International Islamic Financial Market (IIFM).

---

[264] The "CAMELS Rating System" consists of six factors Capital adequacy, Asset quality, Management quality, Earnings, Liquidity and Sensitivity to Market Risk. Camels rating is a supervisory rating system to clarify a bank's overall condition.

[265] Razak and Lautt, *Islamic Financial System Principles and Operations*, 633.

[266]http://www.cbb.gov.bh/ (accessed Nov. 25, 2014).

[267]Razak and Lautt, *Islamic Financial System Principles and Operations*, 653.

4.6.3.2 Roles and Functions of CBB in the Development of Islamic Banking and Finance[268]

The roles and functions of CBB are mentioned in Article 3 of the Central Bank of Bahrain and Financial Institutions Law 2006. It includes:

1. For the kingdom of Bahrain, implement and set regulatory standards for financial institutions.
2. For the Kingdom of Bahrain and financial sector, act as a Central Bank.
3. To enhance the customers confidence and to help the financial sector for further growth and development.
4. To safeguard the interests of depositors and customers of financial institutions.

The powers and duties of CBB are mentioned in Article 4 of the Central Bank of Bahrain and Financial Institutions Law 2006. The CBB is responsible to issue currency, licensing, regulation and supervision of financial institutions and to maintain reserves.

4.6.1.1 Regulatory Framework of Islamic Banks in Bahrain

The Kingdom of Bahrain has mentioned its financial institutions regulatory requirements in the Central Bank of Bahrain Rulebook. The regulatory requirements of Central Bank of Bahrain are applicable to all offshore banking units, Islamic full commercial banks and investments banks. Volume 2 of the Rulebook deals to the Islamic Banks. It contains Prudential Information and Regulatory Framework for Islamic Banks (PIRI).[269]

---

[268] https://www.cbb.gov.bh/assets/CBBLaw/THE_CENTRAL_BANK_OF_BAHRAIN_AND FINANCIAL_INSTITUTIONS_LAW_ENGLISH.pdf (accessed Nov. 20, 2014).

[269] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking*, 193.

a) The Central Bank of Bahrain Rulebook[270]

In 2005, the Central Bank of Bahrain has issued a Rulebook.[271] The Central Bank of Bahrain is the first bank that has adopted comprehensive regulatory framework for Islamic banks. Prudential Information and Regulatory Framework for Islamic Banks (PIRI) is issued by the Central Bank of Bahrain. The main function of PIRI is to enhance the customer's confidence and to regulate and supervise the Islamic banking and finance.[272]

In 2001, Bahrain became the first country to develop and implement Islamic banking regulations. The Central Bank of Bahrain (CBB) has issued Rulebook for the regulation of Islamic finance. The aim of Rulebook is to gather the circulars of Islamic finance relating to regulations. There are seven different Volumes of Rulebook, Volume 1 issued in July 2004 and deals with the Conventional Banks. Volume 2 issued in January 2005 and deals with Islamic Banks. Volume 3 issued in April 2005, deals with Insurance. Volume 4 issued in April 2006, covers Investment Business. Volume 5 and 6 issued in 2007, cover specialized licensees and Capital Market. respectively. Finally, Volume 7 covers Collective Investment undertaking.[273] The volumes are further divided into different modules. Such rules have a binding effect. The Volume 2 of Rulebook of Central Bank of Bahrain deals with the Islamic Banks (PIRI).[274] Broadly it deals with:[275]

---

[270] http://cbb.complinet.com/cbb/microsite/cbb_rulebook.html (accessed May 05, 2014)

[271] Ishrat Husain, Islamic Finance, Prudential Arrangements for Stability and development of Islamic finance, 4.

[272] Inam Ullah Khan, *Legal and Regulatory Framework of Islamic Banking,* 193.
[273] http://www.cbb.gov.bh/page-p-cbb_rule_book.htm (accessed June 11, 2014).
[274] Razak and Lautt, *Islamic Financial System Principles and Operations*, 654.
[275] http://cbb.complinet.com/cbb/microsite/cbb_rulebook.html (accessed June 05, 2014).

i) Auditors & Accounting Standards[276]

This module explains the appointment of internal and external auditors for Islamic banking and financial institutions and their responsibilities.

ii) Business & Market Conduct[277]

The purpose of this module is that the licensees of Islamic banks are responsible to deal with their customers in fair, efficient and open manner.

iii) Capital Adequacy of Islamic Banks[278]

Capital requirement (also known as regulatory capital or capital adequacy) is the amount of capital a bank or other financial institution has to hold as required by its financial regulator. This is usually expressed as a capital adequacy ratio of equity that must be held as a percentage of risk-weighted assets. This module states that all banks should maintain a minimum capital adequacy. Historically the minimum capital adequacy ratio was 12% but presently, Islamic banks should maintain 8% capital adequacy ratio.

iii) Central Bank of Bahrain Reporting Requirements[279]

The purpose of this module is that the Islamic banks should report all matters relating to bank to the Central Bank of Bahrain.

iv) Compensation Module[280]

Under this module the Central Bank of Bahrain has established a Deposits and Unrestricted Investment Accounts Protection Scheme. The purpose of establishing such scheme is that to satisfy the Eligible Account Holder in case of banks failure.

---

[276] http://cbb.complinet.com/cbb/display/display.html?rbid=1821&element_id=303 (accessed June 05, 2014).

[277] Ibid.

[278] Ibid.

[279] Ibid.

[280] Ibid.

The body established to operate and administer the compensation scheme is the deposits and Unrestricted Investment Accounts Protection Board. The Board consists of eleven persons appointed by the Governor of the CBB. In case of bank's failure this scheme helps to protect the bank's customers.

v) Financial Crimes Module[281]

The applicability of this module is on all Islamic banks licensed under the Central Bank of Bahrain. This module combating terrorist financing and money laundering. It explains the polices of anti-money laundering and also highlights the roles, functions and responsibilities of Money Laundering Reporting Officer (MLRO)

vi) Enforcement Module[282]

The purpose of this module is to ensure compliance of regulatory laws by licensees of Islamic banks and also explains mechanism in case of failure of licensee to fulfill the regulatory requirements.

viii) General Requirements[283]

All those requirements which are not cover in any other head comes under general requirements module such as use of trade name or corporate name, books and records and requirements relating to controllers.

ix) Licensing Requirements[284]

It deals with requirement to hold a license, approved persons, licensing conditions, information requirements and processes and license fees.[285] The Central Bank of Bahrain issues license to banks to carry out Islamic banking activity and a

---

[281] Ibid.
[282] Ibid.
[283] Ibid.
[284] Ibid.
[285] http://cbb.complinet.com/net_file_store/new_rulebooks/v/o/Vol_2_LR_Jan_2014.pdf (accessed June 05, 2014).

licensed Islamic bank must accept *Shariah* placement, profit and loss sharing mechanism and *Shariah* deposits.

x) Liquidity/Credit/Operational Risk Management[286]

The Central Bank of Bahrain Rulebook provides a comprehensive guidance relating to risk management and explains all categories individually. The management of bank is responsible to mitigate the liquidity, credit and operational risks.

xi) Public Disclosure Requirements[287]

The public disclosure module requires that the bank should disclose required information to the general public. This enhances the transparency of corporate governance and enhances customer's confidence.

xii) Training & Competency Module[288]

This module explains that the individuals of bank such as board members, auditors, directors, head of risk management, *Shariah* advisors etc. should be competent in terms of knowledge, skill, professional qualifications and experience.

b) Central Bank of Bahrain and Financial Institutions Law 2006[289]

The Central Bank of Bahrain was established on 6 September, 2006 under The Central Bank of Bahrain and Financial Institutions Law 2006. The Central Bank of Bahrain and Financial Institutions Law explains the powers and duties of the Central Bank.

---

[286] http://cbb.complinet.com/cbb/display/display.html?rbid=1821&element_id=8270 (accessed June 05, 2014).
[287] Ibid.
[288] Ibid.
[289]https://www.cbb.gov.bh/assets/CBBLaw/THE_CENTRAL_BANK_OF_BAHRAIN_AND_FINANCIAL_INSTITUTIONS_LAW_ENGLISH.pdf, (accessed Oct. 05, 2014).

c) Adoption of International Standards for Islamic Banks

In 1991, AAIOFI standards were established and adopted in Bahrain with respect to accounting, auditing, *Shariah* and corporate governance practice.[290] CBB has implemented the Basel II requirements for both the Islamic banks and conventional banks.

In the final analysis, the above discussion on 'Regulation and Supervision of Islamic Banks in Different Countries' shows that in Pakistan not much progress has been shown in their regulatory and supervisory arrangements. However, the Central Bank of the kingdom of Bahrain is the first regulatory authority which has introduced the Prudential Information and regulatory framework for Islamic banks. It not only provides the prudential regulatory framework but also the monitoring tools for Central Bank of Bahrain. Similarly, Malaysia also has well-developed regulatory laws for Islamic banking and finance.

The Islamic financial activities are different from conventional financial activities. There are lots of issues due to the lack of regulatory framework of Islamic banks such as in investment account arrangement the profit is distributed between the bank and the investor. Normally, the bank does not bear any loss and all losses are borne by the investor. Nonetheless, in such kind of arrangement, a prudential regulatory framework is needed for the Islamic banks to safeguard the interest of investors from any excessive loss. Therefore, prudential regulatory framework is needed to protect the investor in case of failure of bank.

---

[290] Menara Tun Razak and Jalan Raja Lautt, *Islamic Financial System Principles and Operations* (Kuala Lumpur: International Shariah Research Academy for Islamic Finance, 2012), 747.

Similarly, in Pakistan no guideline or law is enacted which deals to the conversion of conventional banking assets and liabilities into Islamic banking assets and liabilities. And also there is no process mentioned by superior authorities of swap over by a customer from one banking system to another banking system.

Therefore, there is a need to introduce prudential regulatory laws for Islamic banking industry of Pakistan. This is important for growth and development of Islamic banking industry.

The Table below Summaries the Regulatory Frameworks of Islamic Banks:

Table: 3 Regulatory Frameworks of Islamic Banks in Different Countries

	Pakistan	**Malaysia**	**Bahrain**
Regulator	State Bank of Pakistan (SBP)	Bank Negara Malaysia (BNM)	Central Bank of Bahrain (CBB)
Regulatory Arrangements	• State Bank of Pakistan Act 1956.	• Central Bank of Malaysia Act, 2009 • Islamic Financial Services Act, 2013 • Islamic Banking Act, 1983	• The Central Bank of Bahrain and Financial Institutions Law 2006 for regulations. • The Central Bank of Bahrain Rulebook

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

While concluding this research work "Legal and Regulatory Framework of Islamic Banks in Pakistan" and keeping in view the earlier discussion made in Chapter 1, 2, 3 & 4, it is concluded that the laws dealing to Islamic banks in Pakistan are conventional in nature, as there is no special legal and regulatory law implemented in Pakistan dealing to Islamic banks.

From the earlier discussion, it is clear that with the passage of time, Islamic banking in Pakistan has introduced various developments and reforms. But presently, Islamic banking is at nascent stage in Pakistan, therefore, for the development of Islamic banking, the legislature, government, judiciary, regulator, practitioners, researchers, *Shariah* scholars and educational institutions have to fulfill their responsibilities. There are some challenges faced by Islamic banking industry due to the absence of proper and effective legal and regulatory framework, such as, the banking practices vary from bank to bank, only few people have sufficient knowledge of Islamic banking transactions, new Islamic modes of finance constraint, Islamic banks conduct short term investments as compare to long term investments as conducted by conventional banks and it also develop an environment of uncertainty.

Therefore, it is necessary to introduce a separate legal and regulatory framework of Islamic banks in Pakistan.

The Islamic financial activities are different from conventional financial activities. Islamic financial activities are governed and established by the principles of *Shariah*, while conventional financial activities follow secular laws and regulations. Due to the difference in the nature of Islamic and conventional banking activities, they must be governed by separate legal and regulatory laws.

It is clear that Malaysia has introduced well defined legislations for Islamic banks, however, in comparison; there is no Islamic banking law in Pakistan. In Pakistan, Islamic banks are governed by the conventional banking law the Banking Companies Ordinance, 1962 and some Circulars issued by the State Bank of Pakistan. There are many loopholes in the present Ordinance such as section 5(b) and 5(c) of this Ordinance gives definition of banking and banking company, however, it does not define Islamic banking and Islamic banking business. Similarly, this ordinance does not define 'Profit' and there is no method of introduction of products offered by Islamic financial institutions. Moreover, the most important issue in Islamic banks due to the absence of legislative framework is the returns on saving accounts that can hardly be distinguished from the interest offered by the conventional banks. There is no special law for Islamic banks that gives guidelines to Islamic financial institutions.

In Pakistan, the banking courts are established under Financial Institutions (Recovery of Finances) Ordinance, 2001. This ordinance deals with all matters relating to finance. The issue face by Islamic banking and finance in Pakistan, due to the absence of codification of *Shariah* principles is that while deciding the dispute between bank and its customer, the predictability and certainty of court decision gets difficult. The judges are free to interpret Islamic banking transactions. However, the judges are not *Shariah* experts and it is difficult for them to adjudicate on the matters relating to the *Shariah*. Therefore, it is necessary that there must be separate *Shariah* commercial courts established under separate law that deals with the matters of Islamic banks.

The international standard-setting organizations such as the AAOIFI, IFSB, IFA and many other international organizations are informal in nature. These organizations formulate the regulatory and supervisory standards for Islamic banking and finance. However, such standards do not have legal force; countries adopt such standards according to their own will. Such organizations do not have any supervisory authority. Moreover, the Central Bank or the State Bank regulate and supervise the Islamic financial institutions. They introduce laws and provide guideline to stabilize this sector. Different countries follow different laws and regulations for Islamic banks. The regulation and supervision of Islamic banks in Pakistan is not much effective because Pakistan has adopted only few *Shariah* regulatory standards and also conventional banking standards apply on Islamic banking industry such as Basel. There is absence of prudential regulatory laws for the protection of investment account holders. However, the Central Bank of Bahrain has introduced a completely separate regulatory framework for Islamic banks. Lack of prudential regulations, a level playing field and human capital development are the fundamental issues that any country may face while introducing an effective regulatory framework for Islamic banks.

Furthermore, the banking operations for all Islamic banks are the same. There are mostly three kinds of accounts i.e., current account, saving account and investment account. In current account, the deposits are kept in the safe custody of the Islamic banks. In such kind of contract, the capital is guaranteed while, the depositor does not entitle for any return on deposits. Nonetheless, in the case of bank's failure or bank's loss, the amount of loss is much more than the amount of equity. The loss to the bank ultimately affects the depositor of the bank. Similarly, in investment account arrangement, the bank acts as a *mudrib* while the depositor is *rabb-al-mal.* They share profit according to a pre-agreed ratio. While in such kind of arrangements all losses are borne by the depositor. Therefore, it is mandatory that the Islamic banks in Pakistan must have a proper prudential regulatory framework. This will protect the investors from excessive loss and also retain the investor's confidence.

Another issue faced by Islamic banks is when a customer swaps over from conventional banking system to Islamic banking system or Islamic banking system to conventional banking system. There is no law which explains the proper procedure of swap over by the customer. Therefore, there is a need of specific laws for such kind of customers.

Similarly, in Pakistan, there is no law which deals with the conversion of conventional banking assets and liabilities into Islamic banking assets and liabilities. While, the State Bank of Pakistan has introduced the conversion of conventional banking branches into Islamic banking branches. Therefore, it is necessary that a separate law for Islamic banks should be enacted which contain the provision exclusively dealing with the conversion of conventional banking assets and liabilities into Islamic banking assets and liabilities.

In the final conclusion, Malaysia and Bahrain have made necessary legislative frameworks for regulation and supervision of Islamic banks. However, in Pakistan there is no separate legislation for regulation and supervision of Islamic banks in Pakistan. The Islamic banking activities are different from conventional banking activities. Islamic banking activities are based upon the principle of prohibition of interest *(riba).* Therefore, due to the difference in the nature of Islamic and conventional financial activities, it is necessary that Islamic financial activities must be governed by separate legal and regulatory laws.

While concluding this research work on Islamic banks, it has been proved that "The issues faced by Islamic banks of Pakistan due to the absence of proper and effective legal and regulatory framework need to be resolved by designing a suitable framework for Islamic banks of Pakistan." Therefore, it is suggested that the State Bank of Pakistan should present a bill before National Assembly of the state and Parliament should make legislations for Islamic banking and finance. Further, it is important that the legislations must be enforced and implemented by the regulator of Islamic banks.

5.2 Recommendations

While concluding the research topic "Legal and Regulatory Framework of Islamic Banks in Pakistan," here are some recommendations for Islamic banking industry of Pakistan.

- There should be special laws for Islamic banking and finance. Those laws should be based on the teachings of Islam.
- In Pakistan, the Banking Companies Ordinance, 1962 is applicable to Islamic banking as well. Till the time, new laws are enacted and it is recommended that the present ordinance should be amended and must include the definition of Islamic banking and Islamic banking company. And also it should clearly states that the clauses relating to interest are not applicable to Islamic banking system.
- There must be separate regulatory framework for Islamic banking and finance based on the principles of *Shariah*, ensures its compliance by the regulator of Islamic banking and finance.
- It is also recommended that there must be gradual abolition of interest and conversion of conventional banking setup into Islamic banking setup.
- There must be separate legal and regulatory framework for Islamic banks, due to the absence of substantive laws; the courts are free to interpret the transactions relating to Islamic banking and finance. And it is recommended that there must be establishment of *Shariah* commercial courts devoted to deal with matters relating to Islamic banking and finance.
- For the settlement of disputes between Islamic banks and customers, there must be establishment of 'Alternate Dispute Resolution' as provided by other

Islamic countries. This method can help to provide an appropriate, speedy and cheap resolution of disputes between Islamic banks and its customers.

- The international regulations for conventional banking such as Basel are applicable for Islamic banking as well. Indeed the Basel requirements are meant to regulate an interest based banking system. Eventually, there is a need to correlate Basel requirements to Islamic banking and finance.
- In Pakistan a detail criterion is provided for conversion of conventional banking branches into Islamic banking branches. However, there is no process so mentioned for conversion of existing assets and liabilities of conventional banks into Islamic banks. The banks are free to choose any method for conversion. Therefore, it is recommended that a proper mechanism need to be identify for the conversion of existing assets and liabilities of conventional banks into Islamic banks in the *Shariah* compliant manner.
- In Pakistan, there is no law regulating the swapping over of a customer from Islamic banking system to conventional banking system or conventional banking system to Islamic banking system. So, there is a need to identify a proper mechanism through which a customer swap over from one banking system to another.

BIBLIOGRAPHY

Articles

Ashraf, Junaid, and Waqar I. Ghani. "Accounting Development in Pakistan". *The International Journal of Accounting* 40 (2005):175-201.

Ashraf, Muhammad. "Development and Growth of Islamic Banking in Pakistan". *African Journal of Business Management* 7, no.32 (2013):3144-3151.

Davis, Archie K. "Banking Regulation Today: A Banker's View". *Law and Contemporary Problems* 31, no.4 (1966):639-647.

Haron, Sudin. "A Comparative Study of Islamic Banking Practices". *Journal of King Abdulaziz University: Islamic Economics* 10(1998):27-28. Accessed June 07.2014, URL: http://www.kau.edu.sa/Files/320/Researches/51106_21240.pdf.

Hasan, Zulkifli. "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK". *Kyoto Bulletin of Islamic Area Studies* 3, no.2 (March 2010):82-115.

Holden, Kelly. "Islamic Finance: Legal Hypocrisy". *Boston University International Law Journal* 25, no. 341 (2008):42-367.

Husain, Ishrat. "Financial Sector Regulation in Pakistan: The Way Forward". *SBP Research Bulletin* 7, no. 1 (2011):1-44.

Ibrahim, M. Illiyas Seyad. "The Regulatory Framework and Legal Aspects of Islamic Banking and Finance in Malaysia". *In Essential Reading in Islamic Finance*, edited by M. Daud Bakar and Engku Rabiah Adawiah Engku Ali, 271-291. Kuala Lampur: Centre for Research and Training Publication, 2008.

Imran, Muhammad, Shahzad Abdul Samad and Rass Masood. "Awareness level of Islamic Banking in Pakistan's Two Largest Cities". *Journal of Managerial Sciences* 5, no. 1 (2011):5. Accessed April 05, 2014, URL: http://qurtuba.edu.pk/jms/default_files/JMS/5_1/JMS_January_June2010_1-20.pdf.

Kennedy, Charles H. "Islamization and Legal Reform in Pakistan, 1979-1989". *Pacific Affairs* 63, no.1 (spring, 1990):62-77.

Khan, Inam Ullah. "Legal and Regulatory Framework of Islamic Banking". *In Islamic Transactions and Finance: Principles and Developments*, edited by M. Hashim Kamali and Sheila Ainon Yussof, 171-213. Malaysia: The Malaysian Current Law Journal and International Institute of Advanced Islamic Studies, 2013.

Khan, M.Y. "Banking Regulations and Islamic Banks in India: Status and Issues". *International Journal of Islamic Financial Services* 2, no.4.

Khan, Mohsin S. and Abbas Mirakhor. "Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan". *Economic Development and Cultural Change* 38, no.2 (1990):353-375.

Kouser, Rehana, and Irum Saba. "Gauging the Financial Performance of Banking Sector using".

Kuran, Timur, Jonathan Benthall and Bill Maurer. "Speculations on Islamic Financial Alternatives". *The Australian Journal of Anthropology* 17, no.3 (Jun., 2001):28-29.

Memon, Noor Ahmed. "Islamic Banking: Present and Future Challenges". *Journal of Management and Social Sciences 3*, no.1 (spring 2007):1-10. Accessed June 10, 2014.

Muhammad, Illiayas S. *Essential Reading in Islamic Finance.* Kuala Lumpur: Centre for Research and Training Publication, 2008.

Siddique, Ahmed Ali. "Islamic Banking Industry Growing Aimed Challenges". *Journal of Islamic Banking and Finance* 30, no.1 (2013):1. Accessed May 26, 2014, URL:http://www.meezanbank.com/docs/IBIG.pdf.

Books

Abdullah, Fahim, and Muhammad Iqbal. *Challenges Facing Islamic Banking in 21st Century.* Harvard Publishers, 1999.

Ahmad, Khurshid. *Elimination of Riba from the Economy.* Islamabad: Institute of Policy Studies, 1994-1995.

Ali, Salman Syed, and Ausaf Ahmad. *Islamic Banking and Finance: Fundamental and Contemporary Issues.* Jeddah: Islamic Research and Training Institute, 2007.

Ansari, Saalim Salam. *Manual of Banking with Leading Cases.* Karachi: Asia Law House, 1998.

Ayub, Muhammad. *Islamic Banking and Finance: Theory and Practice.* Karachi: State Bank Printing Press, (2002).

Chapra, M. Umar, and Tariqullah Khan. *Regulation and Supervision of Islamic Banks.* Jeddah: Islamic Research and Training Institute, 2000, URL: http://www.sbp.org.pk/departments/ibd/Regulation_Supervision.pdf.

Chaudhri, M. Naseem. *Complete Banking Laws in Pakistan.* Lahore: Lahore Law Time Publications, 2005.

Hussein, Khaled A. *Banking Efficiency in Bahrain· Islamic vs. Conventional Banks.* Jeddah: Islamic Research and Training Institute, 2004.

Khan, Abdul Jabbar. *Non-Interest Banking in Pakistan.* Karachi: Royal Book Company, 1991.

Khan, Khalil ur- Rehman. *The Supreme Court's Judgement on Riba.* Islamabad: *Shariah* Academy, 2008.

Khan, M. Mansoor, and M. Ishaq Bhatti. *Developments in Islamic Banking.* New York: Palgrave Macmillan Houndmills, 2008.

Khan, Mubashir. *Banking laws in Pakistan.* Lahore: Uzair Publications, 2002.

Khan, Tariqullah, and Habib Ahmed. *Risk Management: An Analysis of Issues in Islamic Financial Industry.* Jeddah: Islamic Research and Training Institute, 2001.

Mansuri, M. Tahir. *Islamic Law of Contracts and Business Transactions.* Islamabad: *Shariah* Academy, 2001.

Muhammad, Illiayas S. *Essential Reading in Islamic Finance.* Kuala Lumpur: Centre for Research and Training Publication, 2008.

Nyazee, Imran Ahsan Khan. *Jurisprudence*. Lahore: Federal Law House, 2007.

Razak, Menara Tun, and Jalan Raja Laut. *Islamic Financial System: Principles and Operations.* Malaysia: International Shariah Research Academy for Islamic Finance, 2012.

Smith, Herbert. *Guide to Dispute Resolution in the Middle East.* Dubai: Herbert Smith LLP,2010/2011,URL:http://biztek.edu.pk/downloads/research/jmss_v3_n1/1islamic%20baking.pdf.

Usmani, Muhammad Iman Ashraf. *Meezan Bank's Guide to Islamic Banking.* Karachi: Darul-Ishaat press, 2002.

Legislations

Banking and Financial Institutions Act, 1989 (Malaysia)

Banking Companies Ordinance, 1962 (Pakistan)

Central Bank of Bahrain and Financial Institutions Law, 2006 (Bahrain)

Central Bank of Bahrain Rulebook (Bahrain)

Central Bank of Malaysia Act, 2009 (Malaysia)

Companies Act, 1965 (Malaysia)

Companies Ordinance, 1984 (Pakistan)

Financial Institutions (Recovery of Finances) Ordinance, 2001 (Pakistan)

Islamic Banking Act, 1983 (Malaysia)

Islamic Financial Services Act, 2013 (Malaysia)

State Bank of Pakistan Act, 1956 (Pakistan)

Web links

http://www.aaoifi.com/.

http://www.bnm.gov.my/.

http://www.cbb.gov.bh/assets/A%20R/CBB%20ANNUAL%20REPORT%202010%20English%20FINAL.pdf.

http://pakistanconstitutionlaw.com/p-l-d-2000-sc-225/.

http://qurtuba.edu.pk/jms/default_files/JMS/5_1/JMS_January_June2010_1-20.pdf.

http://www.albaraka.com/default.asp?action=article&id.

http://www.meezanbank.com/docs/IBIG.pdf.

http://www.sbp.org.pk/departments/ibd/FAQs.pdf.

http://www.sbp.org.pk/ibd/2010/C2-Anexx.pdf.

http://www.sbp.org.pk/search/results.asp?cx=002167901857236840991:v55i2sdnxfs&cof=FORID:11&q=%20list%20of%20islamic%20banks.

http://www.shahfoundationbd.org/hannan/article10.html.

http://www.ifsb.org/.

http://www.sbp.org.pk/.