

**ISLAMIC BANKING AND CONVERSION OF CONVENTIONAL BANKING  
TO ISLAMIC BANKING IN PAKISTAN**



**BY**

**MUHAMMAD UMER ARIF**

**2008**

Dissertation submitted to the Bahria University in partial fulfillment of the requirements for the degree of Bachelors in Business Administration (Honors)

**ISLAMIC BANKING AND CONVERSION OF CONVENTIONAL BANKING TO  
ISLAMIC BANKING IN PAKISTAN**

**Keywords:** Islamic banking, conventional banking, conversion of banking system, central bank and Islamic banking

**Abstract**

In 1979, by the order of the president of Pakistan, conventional banking was converted to Islamic banking. At that time Pakistani economy was based on interest based banking. Government of Pakistan established a council in 1962 called Council of Islamic Ideology, and its main objective was to study the Islamic economic system and giving the guidelines to convert the existing banking system to Islamic banking system.

The phase of transition started in two main phases. In first phase, the basic infrastructure was changed to Islamic banking system so that strategies could be developed to introduce full fledged Islamic system. The process of Islamisation from conversion of three specialized credit financial institutions The House Building Corporation, The Investment Corporation of Pakistan and The National Investment trust. State bank of Pakistan ordered all commercial banks to convert their operations according to Islamic modes of financing. After successful implementation of first phase, Second phase was to introduce new instruments for financing and investment under Islamic modes and eliminate all sorts of conventional banking from the economy.

Presently Islamic modes of financing are in practice in all banks of Pakistan. Major modes of financing are Mudarabah, Musharakah, Murabaha, hire purchase, Leasing, Diminishing Musharakah, Mark-up, Mark down, investment in equity capital, rent sharing and profit and loss sharing.

State bank of Pakistan is the apex in the monetary system in Pakistan and responsible for efficient working of money markets and capital markets. To control the economy, State Bank sets minimum and maximum rates of returns on investments and financing.

Banks and borrower mutually choose a rate of return between these limits. In order to safeguard interest of depositors/investors, state bank is continuously making and implementing policies. These are mainly concerned with cash reserve requirements, credit allocation to each industry according to annual development plan and changes in margin requirements.

At present all banking system in Pakistan is according to Islamic modes of financing and banks are competing with each other to give the best rate of return to their depositors. Banking Tribunal ordinance is working to resolve disputes between the financier and borrower. Time to time state bank of Pakistan is making recommendations to ensure that all requirements of Islamic financing are being met.

## Table of Contents

<b>Contents</b>	<b>Page No.</b>	
Chapter 1	<b>INTRODUCTION</b>	1
Chapter 2	<b>Literature Review</b>	
	2.1 <i>Theoretical Review of general terms in Islamic Banking</i>	17
	2.2 <i>Objective of Islamic banking system</i>	19
	2.3 <i>The Islamic commercial banking system</i>	
19		
	2.4 <i>Central banking and Monetary policy</i>	26
	2.5 <i>Savings and investments</i>	29
	2.6 <i>Financial risk management</i>	32
	2.6.1 <i>Withdrawal risk</i>	33
	2.6.2 <i>Asset management risk</i>	35
	2.6.3 <i>Bank capital and deposit investment</i>	35
	2.7 <i>Some performance and operational matters in Islamic Banking</i>	36
	2.7.1 <i>Stability of Islamic banks</i>	36
	2.7.2 <i>Liquidity management</i>	37
	2.7.3 <i>Quasi-equity and Securitization</i>	38
	2.8 <i>Legal issues and dispute settlement</i>	38
	2.9 <i>Regulation of Islamic economic/banking law</i>	39
	2.10 <i>Theoretical financial analysis of conventional banks And Islamic banks</i>	39
Chapter 3	<b>METHODOLOGY</b>	44
	3.1 <i>Research Methodology</i>	44
	3.1.1 <i>Collection of primary data</i>	45
	3.1.2 <i>Collection of secondary data</i>	45
	3.1.3 <i>Sampling for depositors' questionnaire</i>	46
	3.1.3.1 <i>Depositors' questionnaires</i>	47
	3.1.4 <i>Sampling for banking questionnaire</i>	50
	3.1.4.1 <i>Banking questionnaire</i>	50

	3.1.5	<i>Things considered while gathering Data and selecting sample</i>	53
	3.1.6	<i>Limitations of Research</i>	54
Chapter 4		<b>CASE STUDY- CONVERSION FROM CONVENTIONAL BANKING TO ISLAMIC BANKING IN PAKISTAN</b>	56
	4.1	<i>Analysis of questionnaires</i>	57
	4.1.1	<i>Depositors' questionnaires research findings</i>	58
	4.1.2	<i>Banking questionnaire research findings</i>	61
	4.2	<i>Conversion process of banking system in Pakistan</i>	63
	4.3	Financing and credit operations under new system	67
	4.4	Operations of Specialized Credit Institutions	68
	4.5	Current practices	69
	4.5.1	Mudarabah	70
	4.5.2	Musharakah	72
	4.5.3	Participation Term Certificates	73
	4.5.4	Mark up	74
	4.5.5	Hire purchase	75
	4.5.6	Other Instruments	76
	4.6	Choice of instruments	76
	4.7	Rates of return and charges	77
	4.8	Monetary policy and bank regulations	78
	4.8.1	Legal framework	80
	4.9	Challenges faced by Islamic banks	81
Chapter 5		<b>SYNOPSIS</b>	
	5.1	Conclusion	83
	5.2	Recommendations	86
	5.3	Limitations of Research	87
		<b>APPENDIX A:</b>	
		<i>DISSERTATION PROPOSAL</i>	88
		<i>Bibliography</i>	98