Islamic Banking in Practice: the Case of Pakistan

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ABSTRACT

In Islamic banking rules apply which differ from those in traditional banking. This article first discusses the consequences of Islamic banking for financial operations in general, then goes on to examine the Islamic procedures introduced in Pakistan's banking sector since 1985. Considering the drastic change in procedures, the effect of Islamization on this sector has been moderate. One reason for this is that banks in Pakistan have consistently opted for financial instruments closely resembling interest-based finance. Another reason is that their behaviour has been determined to a large extent by the fact that they are state-owned.

INTRODUCTION

The best-known property of Islamic banking is the absence of interest-based finance, where interest is to be interpreted as a pre-set return on capital. Since the first experiments with interest-free banking in Egypt in the early 1960s, the number of banks applying that principle has been rising continuously. This expansion was particularly strong during the 1970s as a result of the oil boom, and it received a new impetus in the early 1980s when Iran and Pakistan converted their financial sectors to exclusively Islamic banking procedures.

This article discusses the theoretical effects of the application of Islamic procedures for a banking sector as well as the practical experience of Islamic banking in Pakistan. After a brief look at the religious basis for the prohibition of interest, the discussion turns to the various consequences of interest-free banking according to economic theory. This is followed by an examination of the Islamic financial instruments which have been devised in Pakistan since 1985 to replace interest-based finance, and a discussion of banking practice in Pakistan. Finally, the main differences between Islamic banking and the traditional financial system are summarized in the conclusion.

The authors wish to thank three anonymous referees for useful comments on an earlier version of this paper.

GENERAL ASPECTS OF ISLAMIC BANKING

Since the Arabic word *riba* means both 'usury' and 'interest', the Koranic prohibition of *riba* raises questions of interpretation. Most religious scholars of Islam, however, adhere to the broad interpretation according to which both usury and interest are prohibited. There are two reasons behind this position (Cunningham, 1990: 3–4; Zineldin, 1990: 80):

1) Exchange of monetary value for monetary value is prohibited. A transaction involving capital must be linked to a real transaction. Financial resources must be used productively for the betterment of the community and money is not allowed to feed on itself.

2) The capital supplier must share the risks faced by the capital user. When the borrower runs a loss, the lender must participate in that loss through a reduction of the principal. It is better still if the lender gives the borrower a chance to make up the loss.

From this it follows that financial instruments other than those using prefixed returns on capital are permitted. For example, the remuneration which depositors obtain from Islamic banks must be based on the profits and losses made by the banks. Similarly, Islamic banks are meant to make or lose money in direct proportion to the profitability of the operations they have helped to finance.

The prohibition of interest-bearing loans has consequences for various economic activities. This holds *a fortiori* for the financial sector to which this discussion is limited. One such effect is obvious: Islamic banking is cut off from a whole set of (interest-based) financial instruments which have otherwise proved to be useful. Whether this is a serious loss depends very much on the efficiency of the alternative instruments and the way in which they are applied. There are both theoretical and practical sides to this issue: the theoretical side has attracted considerable attention in the economic literature (a recent example being Presley and Sessions, 1994). The practical aspects will be taken up later in this article. Other effects of the introduction of Islamic banking relate to the stability of the banking sector, the volume of demand and supply of funds, moral hazard, monetary policy and the price of loans to the public sector; it is to these that we turn now.

In a traditional financial system banks guarantee the nominal value of deposits entrusted to them. However, when a bank is making losses, the ratio of the actual value of its assets to the nominal value of the deposits deteriorates. When this process cannot be reversed, the bank's capacity to live up to its guarantee is threatened. Depositors will withdraw their funds, thereby further weakening the bank's position. The resulting crisis of confidence may even affect other banks.

As Khan (1986: 33–1) points out, such a threat to the stability of the banking sector does not exist in Islamic banking, where a bank's losses are
directly expressed in the (reduced) value of the deposits. Liabilities never exceed assets, so an Islamic bank cannot default. While acknowledging this conclusion, however, it should be realized that the stability of an Islamic banking system is not immune to banks’ losses. In fact, even in the absence of losses, differences between profit rates of individual banks may give rise to large-scale shifts of deposits from less to more profitable banks. In other words, under the Islamic system stability may be threatened by a liquidity crisis.

Another issue is the effect which volatile returns on borrowed capital have on supply and demand. The demand reaction will depend to a large extent on the expectations and risk attitudes of capital users. Users who are uncertain about the returns of an investment to be financed with borrowed capital may welcome an arrangement where the price to be paid for the use of funds varies with the profits made with these funds. Such an arrangement helps to reduce the borrower’s risk and this may well increase demand for borrowed capital. Borrowers who are confident about the profitability of an investment may be less enthusiastic, however, as their net-expected revenue may be affected adversely.

As to the effect of increased uncertainty on savings — that is, on the increase in capital availability — two main views can be distinguished. On the one hand, Fisher (1930) and Boulding (1966) argue that time preference falls when future income becomes less certain. Hence, the value attached to future consumption will rise relative to the value of present consumption, so the propensity to save will increase. The other view, loosely attributed to Marshall, is that an increase in uncertainty induces a preference for present, relatively certain consumption above uncertain future consumption. As a result the propensity to save will fall.1 Thus we see that demand for loans as well as supply of loans in an Islamic system may be affected by two forces operating in opposite directions: without clear empirical evidence, the overall effect cannot be predicted.

A potentially serious issue in Islamic banking is that of moral hazard. Lenders are encouraged — and in some cases even required — to adopt a lenient attitude towards borrowers who cannot fulfil their obligations. There is a real possibility that opportunistic borrowers misuse this rule. Furthermore, in a system of profit-and-loss sharing, it is in the borrower’s interest to undervalue his profits. The complexities involved in profit determination provide considerable room for profit manipulation. Shareholders are not very vulnerable in this respect: whatever they lose in terms of dividend due to understated profits they gain over time in terms of share value. Further, holders of profit-and-loss sharing deposits who are not satisfied with the rate of return can shift their deposits to another bank. But loans to economic

1. It stands to reason that the effect of an increase in uncertainty on savings also depends on a possible concomitant change in the rate of return (see Khan and Mirakhor, 1990: 357).
actors other than banks cannot be withdrawn so easily. The creditors involved
are in a vulnerable position vis-à-vis debtors who wish to minimize the costs of
borrowed money by understating their profits.

Another problem concerns monetary policy. In an interest-based financial
system monetary authorities use the discount rate to influence the banking
sector's willingness to provide credit: an increase in the discount rate tightens
the credit market and vice versa. Obviously, this policy instrument cannot be
used in the Islamic system. There are of course alternative instruments that
monetary authorities can apply, but the widespread usage of the discount
rate as an instrument for monetary policy purposes in traditional systems
illustrates its importance. The loss of this instrument can therefore be
significant. On the other hand, Meenai (1984: 250) suggests that Islamic
banking reduces the need for monetary policy, as it links money creation
directly to productive activities and, therefore, limits the danger of inflation.

Finally there is the matter of public loans in the context of Islamic
banking. The problem here, of course, is that the public sector typically does
not make profits, so the basis for determining the price to be paid by the
public sector for borrowed capital is missing. For this reason some
commentators argue that the public sector should not be allowed to run a
deficit. In Pakistan, however, where public deficits are a common
phenomenon, public securities are sold at a pre-set discount. Clearly this
solution is at odds with the general prohibition of pre-fixed returns.

ISLAMIC FINANCIAL INSTRUMENTS IN PAKISTAN

For obvious reasons, the change from a traditional financial system to a
system based on Islamic principles has stronger repercussions for the
banking sector than for most other sectors of economic activity. With the
introduction of such a system in Pakistan in 1984, new procedures and
instruments had to be developed and introduced with a minimum of
disturbance. The State Bank of Pakistan (SBP) played a pivotal role in this
process by issuing very detailed instructions for the ways in which banks
should deal with their liabilities and assets. The introduction of Islamic
principles was much facilitated by the fact that state-owned banks held an
overwhelming share (nearly 90 per cent) of the market of banking activities.
In this section, the new system as foreseen by the SBP is discussed: the
conversion of deposits is described only briefly, more attention being given to
the views of the SBP regarding the new modes of lending.

Before the introduction of Islamic banking domestic banks paid
depositors a uniform rate of interest as indicated by the SBP. Thereafter
the remunerations paid out on profit-and-loss sharing (PLS) deposit
accounts were allowed to differ between banks, but the procedure for
calculating the remuneration was prescribed by the SBP. The SBP had two
reasons for this. The first derived from a possible conflict of interest between
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PLS-account holders and banks' shareholders who may wish to understate official profits in order to minimize PLS-returns. The prescribed procedure is thus meant to protect PLS-deposit holders. The second reason applied only for the transition period during which banks still held interest-based claims dating from before the change-over. As it was considered inappropriate to pay returns on PLS-deposits out of income obtained from interest-based claims, banks had to distinguish between the returns from interest-based claims and from other claims. The procedures laid down by the SBP to deal with this problem were rather complex and are beyond the scope of this article.  

In June 1984, in a letter circulated to all banks, the SBP laid down the outlines of the modes of finance it considered to be in accordance with the interpretation of Islamic banking in Pakistan. These modes correspond with three types of finance, namely, lending on social grounds, trade-related finance and investment finance. The first type consists of loans from the SBP which banks pass on to small, destitute borrowers or to disaster-stricken areas; they are provided against, at most, a service charge. Since these loans constitute only a very small part of banks' operations, we will concentrate here on the modes of finance connected with trade and investment.  

In the sphere of trade-related finance six instruments can be distinguished: mark-up pricing or murabaha; financing against a development charge; financing with buy-back agreement; discounting of trade bills; leasing; and hire-purchase. As a precaution during the initial learning period the SBP required minimum and maximum rates of return on these modes of finance of 10 and 20 per cent per year. Most of these trade-related modes of finance are traditional instruments which are considered acceptable under Islamic banking, but it is worth examining the first two more closely.  

- Under mark-up pricing the bank purchases goods for the borrower who agrees to pay a higher price at a future date. This instrument is typically intended for short-term trade finance. During the period covered by this transaction — often three months — the bank remains the owner of the goods and bears the attendant risk. The surcharge depends on the type of commodities involved in the transaction and on the credit rating of the borrower: in this respect the difference with interest-based credit is minimal. However, the mark-up should not be related to the loan period. Further, it should not be raised if the loan period is extended, nor should the borrower be penalized in any other way in case of late payment.  

- Development finance is provided by banks for irrigation projects and for machines and equipment for use in agricultural activities. The price is fixed...
as a pre-arranged share of the profits. Although it has been classified under trade-related finance, this mode is clearly related closely to investment activities.

The SBP outlined five types of finance for investment purposes: mudaraba certificates; profit-and-loss sharing or musharaka; participation term certificates (PTCs); rent sharing; and equity participation. For these instruments the SBP required a minimum expected rate of return of 10 per cent per annum, with no fixed maximum. As equity participation is a well-known instrument, only the first four modes are described below.

- **Mudaraba** contracts are co-operation agreements between an investor who contributes capital and an agent who contributes his efforts and skills. Financial losses are borne entirely by the investor; the agent loses the rewards for his efforts. Profits are shared between the investor and the agent. Mudaraba participation certificates may be transferable.
- In general, musharaka indicates transactions in which parties contribute capital for a specific project and share the risks and revenues according to pre-arranged ratios. In Pakistan, however, PLS-contracts or joint ventures apply a somewhat different interpretation of musharaka as they include elements of mudaraba. The PLS-contract cannot be traded.
- PTCs are very similar to PLS-contracts, except that PTCs are transferable.
- Rent sharing is an agreement among joint owners of a building to distribute rental revenues according to fixed shares.

The SBP has recommended the use of specific modes of finance for specific transactions: Table 1 gives a summary. It appears that mark-up pricing is considered an appropriate financial instrument for a wide variety of purposes. The table also shows that the distinction between trade-related and investment-related finance is not applied rigorously. A trade-related instrument such as mark-up pricing is also considered appropriate for some investment activities. From a religious point of view, a distinction can be made between 'weak' and 'strong' modes of finance, depending on the extent to which risk and return are genuinely shared between the supplier and the user of a fund. Thus, PLS (musharaka) and trust financing (mudaraba) — in contrast to mark-up pricing — are examples of strong modes of finance.

**THE PRACTICE OF ISLAMIC BANKING IN PAKISTAN**

This section reviews the experience of Pakistan’s financial sector with Islamic banking, with particular reference to two aspects: the remunerations which...
### Table 1. Recommended modes of finance for different purposes

<table>
<thead>
<tr>
<th>Purpose</th>
<th>MUP</th>
<th>TrB</th>
<th>BB</th>
<th>Lea</th>
<th>HiP</th>
<th>DCh</th>
<th>PLS</th>
<th>EqP</th>
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MUP = mark-up pricing; TrB = discounting trade bills; BB = buy-back financing; Lea = leasing; HiP = hire-purchase; DCh = financing against a development charge; PLS = profit-and-loss sharing; EqP = equity participation; PTC = participation term and mudaraba certificates; RtS = rent sharing.

**Source:** State Bank of Pakistan (1984: Annexure II).

banks pay on profit-and-loss sharing deposits, and the way in which banks actually use the modes of finance already described.

With the introduction of Islamic rules banks in Pakistan obtained the discretionary power to determine remuneration on deposits as long as they applied the detailed rules on which the SBP insisted. The banks, however, have tended to use their new freedom with restraint, and have avoided fluctuation in pay-out rates in proportion to profits. The reason is of course that volatile returns on PLS-deposits would involve significant differences between returns offered by different banks. Mobility of deposits would increase considerably, possibly threatening the stability of the financial sector. In practice, the difference between the rates paid out by different banks on PLS-deposits since 1985 appears to have been less than two percentage points. If one confines the comparison to just the domestic banks, the difference is no more than 1 per cent (State Bank of Pakistan, 1990).

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6. From figures collected by N. A. Zaidi and reproduced in Khan and Mirakhor (1990), it might even be concluded that rates of return on PLS-deposits have not generally reflected banks' profit rates.
The recommendations of the SBP regarding the modes of finance (described above) were meant to provide an array of financial instruments appropriate for Islamic banking which the banks would subsequently refine in day-to-day practice. In reality, however, banks have shown a strong inclination to use only a few of these modes of finance, namely those which most resemble interest-based instruments. Thus, in trade-related finance mark-up pricing has become the dominant financial instrument. One version, the mark-up with buy-back contract, has become especially popular because of its convenience for banks.

In mark-up transactions the bank has to deal with the seller as well as with the user/borrower. In mark-up with buy-back contracts, however, the user/borrower purchases the goods from the original seller, sells the goods on to the bank, and immediately buys them back against a higher (marked-up) price to be paid at a later date. Consequently, the bank is dealing only with the user/borrower and, more importantly, it is not involved in the underlying commodity transaction. While the bank remains the owner of the goods during the loan period, a mark-up with buy-back contract allows the bank to concentrate on the financial aspects of trade-related finance.

While this arrangement minimizes the difference between commercial credit in the interest-based and in the Islamic system, a discrepancy remains in terms of the position of banks in case of default. As already indicated, the automatic accumulation of mark-ups is prohibited under the Islamic system. If mark-up borrowers do not repay their loans within the agreed period and refuse to enter into new contracts, they are liable only for the mark-up price plus liquidated damages to the amount of 20 per cent of this price. Especially in cases of deliberate default, the extent of the banks' losses therefore depends very much on the speed of action of the law courts. However, the Islamic Banking Tribunals which were established for this purpose in 1984 have not been effective in reducing delays in these cases (this will be discussed below). With no power to enforce contracts, banks often have to simply reschedule non-performing loans.7

In investment-related financing too, banks have restricted themselves, generally speaking, to using only a few of the instruments laid out for them. During an initial period, participation term certificates (PTCs) were applied fairly widely, but the experience was not favourable. In conversations with the authors, bankers emphasized that it appeared very difficult to determine accurately and indisputably the amount due to the lender under profit-and-loss sharing when it is in the borrower's interest to understate profits. Because of this problem, a new instrument, the term finance certificate or

7. Remarkably, in Iran, where Islamic banking rules are generally adhered to more strictly, the moral hazard problem has been addressed by allowing banks to include a penalty clause in loan contracts under which borrowers can be charged 12 per cent per year of outstanding, unpaid loans. See Anwar (1992: 1094).
Table 2. Type and usage of financial instruments in Pakistan's banking sector

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Type of return</th>
<th>Typically Islamic</th>
<th>Frequently used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark-up pricing (murabaha)</td>
<td>fixed</td>
<td>partly</td>
<td>yes</td>
</tr>
<tr>
<td>Discounting bills</td>
<td>fixed</td>
<td>no</td>
<td>yes</td>
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<tr>
<td>Leasing</td>
<td>variable</td>
<td>no</td>
<td>no</td>
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<tr>
<td>Hire-purchase</td>
<td>fixed</td>
<td>no</td>
<td>no</td>
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<tr>
<td>Lending against</td>
<td>fixed</td>
<td>yes</td>
<td>no</td>
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<tr>
<td>development charge</td>
<td>variable</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>PLS (musharaka)</td>
<td>variable</td>
<td>no</td>
<td>yes(^a)</td>
</tr>
<tr>
<td>Equity participation</td>
<td>variable</td>
<td>no</td>
<td>no</td>
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<tr>
<td>PTCs</td>
<td>variable</td>
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<td>no</td>
</tr>
<tr>
<td>TFCs</td>
<td>fixed</td>
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<td>yes</td>
</tr>
<tr>
<td><strong>Mudaraba certificates</strong></td>
<td>variable</td>
<td>yes</td>
<td>no(^b)</td>
</tr>
<tr>
<td>Government securities</td>
<td>fixed</td>
<td>no</td>
<td>yes</td>
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</table>

Notes:
- a) only for long-term finance, not in general
- b) except for investment funds

Source: personal communication with authors.

TFC, has gradually replaced the PTC. In effect, the rate of return on TFCs approximates the going rate of interest. Reviews of the performance of underlying investments do not play a significant role in the determination of the price (see also Cunningham, 1990: 50). TFCs therefore get around a serious problem for the lender, but they cannot be said to sit easily with Islamic requirements.

**Mudaraba** can in principle be used between individual actors (an investor on the one hand and an agent offering effort and skills on the other) for all sorts of industrial, commercial and agricultural activities. In practice, however, it is mainly applied as an umbrella for investment funds. Banks invite clients to invest in funds to which they apply their financial skills. Shares in these funds may be tradable in stock markets.

Table 2 provides information about the usage of the financial instruments discussed so far. It shows that banks have a strong preference for instruments which were also in use before 1985 or, if these have been ruled out since, for those instruments which most closely resemble the traditional ones. In fact, it has been estimated that mark-up pricing covers 80 to 90 per cent of short-term operations, a tendency which has also been observed in other countries.\(^8\)

Furthermore, the rules of Islamic banking are not applied to financial transactions with the rest of the world. The reason for this is, of course, that such transactions would be severely compromised if other parties had to conform to such unfamiliar rules and constraints. As foreign banks in

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\(^8\) According to information collected by the authors; see also Zineldin (1990: 183).
Pakistan are more involved with external financial transactions and have a larger share of foreign exchange deposits than domestic banks, their activities have been affected to a lesser extent by the shift to Islamic rules.

CONCLUSION

Having examined the financial instruments and the banking practices adopted by Pakistan since 1985, we now compare the country's banking sector before and after Islamization. For the purposes of this article, the comparison will concentrate on economic arguments, although it must be recognized that Islamic banking has not been introduced for primarily economic reasons. In making this comparison, we will again focus on some of the aspects of banking which have already been mentioned, together with the question of the profitability of the banking sector under the different systems.

Flexibility

In 1984 the financial sector in Pakistan — as in many other developing countries — was severely repressed. Domestic banks were state-owned, the rate of return on deposits was fixed at a low level and banks' lending operations were regulated by a national credit plan stipulating direction and conditions of bank loans. After Islamization the banks obtained some freedom in determining remuneration rates on deposits. On the other hand, the range of permissible financial instruments was reduced, and the credit plan remained in force. In the coming years the banking sector may gain additional freedom as recent moves towards privatization of some state-owned banks take effect, but this development is not connected with the Islamization process itself.

Stability

It was argued above that stability in Islamic banking is threatened when banks offer significantly different remunerations on deposits in line with differences in profit rates. In reality, however, remunerations on deposits offered by individual banks in Pakistan under Islamic banking have deviated little from the sector's average, thus keeping the mobility of deposits in check. However, the absence of a link between remunerations on deposits and banks' profit rates also implies that the solvency improvement connected with Islamic banking has not been achieved. As a result, the requirements which Pakistani banks must meet to maintain stability are in line with those prevailing in the traditional system. For example, reserve requirements have been fixed at 35 per cent of the value of demand and term deposits.
Furthermore, banks in Pakistan are in the process of improving their ratios of own capital to total assets in accordance with the requirements of the Bank for International Settlements. In other words, the move towards Islamization has brought little or no practical change as regards stability considerations.

The Volume and Composition of Savings and Investments

Volatile deposit remunerations may affect the propensity to save and/or the willingness to hold savings in bank deposits. Since banks in Pakistan have made a point of stabilizing remunerations on deposits, the real effect of Islamization on volume and composition of savings in Pakistan will have been mild at most. In terms of the asset side of the banks' balance sheets, we have seen that banks have shown a strong preference for instruments resembling those in use in traditional banking, so here again the effect of Islamization may be limited. According to bankers' estimates, banks have invested about 50 per cent of their assets in government bonds, although the required rate is only 30 per cent. The attraction of government bonds is not their high returns, but the security they offer in comparison to other bank loans, which are open to moral hazard problems.

Moral Hazard

When borrowers' behaviour is opportunistic, the determination of returns on profit-and-loss sharing loans is likely to be difficult and costly. Although an effective juridical system could help to contain the transaction costs, the special Banking Tribunals set up in 1984 did not decisively reduce the problem of contract enforcement, and since 1989 the Tribunals have not even been operational. At the same time, the political influence exercised on lending operations by the nationalized banks lowers the recovery rate on bank loans in Pakistan. Furthermore, politically-inspired loans are not provided on the basis of an economic evaluation. For these various reasons deliberate default was and still is a serious problem. According to informal estimates by the World Bank, an average of 25 to 30 per cent of bank loans are non-performing. Bank officials estimate that the corresponding figure for agricultural and industrial loans in certain regions could be as high as 60 per cent.

Monetary Policy and Public Loans

Generally speaking, the absence of a discount rate handicaps monetary policy. In Pakistan, however, the effect has been minimized because domestic
banks are subject to direct controls. Where necessary, banks receive direct instructions about the volume of their lending operations, enabling monetary authorities to manage without the discount rate (see Khan and Mirakhor, 1990: 21).

Loans to the public sector are more of a problem: as noted above, such loans cannot be based on a profit-and-loss sharing principle. A genuine solution to this problem has not yet been found. In practice, returns on government securities in Pakistan are still pre-fixed, although the term ‘interest’ is avoided. The Federal Sharia Court ordered the Government of Pakistan to abolish all laws containing a provision for interest by June 1992, but the Government appealed against this ruling in the Supreme Court (see Anwar, 1993: 961).

**Profitability**

According to official statistics, the trend in banks’ profit rates has not altered significantly since 1985. The mildly downward direction of reported profits observable before 1985 continued after Islamization (State Bank of Pakistan, 1990). However, the real question is whether the published figures are an adequate representation of the situation. Banks are suspected of rolling over non-performing loans instead of writing them off, implying that banks’ losses may be seriously under-reported.

Table 3 summarizes the conclusions derived from the comparative analysis of the Islamic and the traditional banking system presented here. Column (1) indicates differences between the two systems in a general, theoretically-
oriented comparison, while column (2) presents differences in the actual situation in Pakistan before and after 1985. The table shows that a theoretical analysis might predict the effects of Islamization to be greater and less favourable, on the whole, than they appear to be in practice. Two explanations can be given for this observation. Firstly, banks have, since Islamization, opted consistently in favour of financial procedures resembling interest-based instruments. Secondly, the actual position of the banking sector in Pakistan is determined to a very large extent by institutional conditions which have not been influenced by Islamic prescriptions. Although financial procedures have changed drastically since the introduction of Islamic banking, the economic impact has been moderate.

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