

Strategic Directions for Developing an Islamic Banking System

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Abstract: This paper argues that Islamic banking does not merely imply an interest-free banking system; rather it is banking in consonance with the ethos and value system of Islam and governed by the principles and rules laid down by Islamic *Shari'ah*. The question then arises as to why the Islamic financing system has not been fully realized in Pakistan? Furthermore, which direction should the government take to establish a sustainable Islamic banking system? The study is conducted with a Strategic Management Approach to explore a practical route for developing a growth oriented Islamic banking system in Pakistan. Critical questions are raised to analyze the dynamics of Islamic banks in Pakistan. Then, using a questionnaire, senior bankers are interviewed to add their insight on the issue. The study finally recommends strategic directions for developing a growth oriented Islamic banking system in the country.

I. Introduction

Islamic banking, generally referred to as interest-free banking has been gaining popularity in the recent past. The main pillar of Islamic finance is the prohibition of interest. Unlike conventional banking where interest is an integral part of the banking system, Islamic banking avoids interest in all bank transactions (Samad and Hassan, 1999). The banking system in Pakistan is undergoing a transition from a conventional model of banking

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to the new concept of Islamic banking, based on principles of Islamic economics. The new system should not only eliminate interest-based transactions but also introduce the concept of *zakāh*, a contribution to the poor (Molla *et. al*, 1988). The prohibition of *ribā* is based on the arguments of social justice and equality.

The elimination of interest in Islamic banking does not mean a zero-return on capital; rather, Islam forbids a fixed predetermined return for a certain factor of production (Ahmad, 1994). The main idea is that there should not be any predetermined benefit attached to the capital. Islam permits profit sharing, even though the profit sharing ratio is predetermined, the ratio of return is not. Highlighting Islamic banking principles, Khan (1986), in an IMF staff paper, states that the Islamic model of banking based on principles of participation bears a striking resemblance to proposals made in the literature for reforms of banking systems in many countries. The Islamic system may well prove to be better suited to adjusting to the shocks that result in banking crises and disruption on payment mechanisms of the country (Khan, 1986: 19).

Scharf (1983), while propagating the case of Islamic banking, states that Islamic banks could make a useful contribution to economic growth and development particularly in a situation of recession, stagnation and low-growth because the core of their operations is oriented towards productive investment. It is further argued that an Islamic system based on the principles of the *Shari'ah* is not only feasible but also profitable (Scharf, 1983).

Western countries are also realizing the truth that interest is an unbearable burden for developing countries. Canada has waived off all interest and Australia has made similar moves. President Mitterrand of France has officially suggested in the Group-7 meeting that at least 30-35% of the present interest element of debt should be waived (see Ahmad, 1994: 188). The purpose of Islamic banking is to develop a financial system which revolves around justice and morality (Ayub, 2002).

In view of the surging wave of Islamic banking throughout the world, the government of Pakistan introduced interest-free banking on a nationwide scale in the late 1970s (the details are explained in section II). A national level strategy was devised to implement the plan, but in view of the mammoth task, it was decided to Islamize the banking system in phases. Despite apparent government efforts, however, Islamic financing in Pakistan could not be practiced in its true spirit and many challenges are still faced by the banking sector in its implementation.

This paper, attempts to explore the strategic policy orientation needed for the promotion of Islamic banking in Pakistan. It is hypothesized that the current policy directions are not facilitating Islamic banking in Pakistan and a number of rational impediments are hampering the system's progress.

This paper is divided into four sections. Section 2 discusses the evolution of Islamic banking in Pakistan focusing on the progress made in the sector. It also identifies factors impeding the development of Islamic banking in Pakistan. Section 3 explores strategic directions and presents the views of bankers relating to the obstacles in the execution of Islamic principles in the banking sector. Tabulated results along with graphical sketches are discussed in detail. Section 4 finally concludes the study and gives some policy implications.

II. Environmental Analysis

Analysis of the operating environment is extremely important for determining organizational directions. The organization must be true to its objectives and it must show progress towards achieving these objectives. It must also be economically stable and have sustainable growth in an open environment. The following section attempts to investigate these basic issues with respect to Islamic banking in Pakistan.

2.1 Islamic banking in Pakistan

The era of 1981 earmarked the formal implementation of interest-free banking in Pakistan on a profit and loss sharing (PLS) basis. From July 1 1985, all commercial banking in Pak Rupees was declared by the government to be made interest-free. From this date, no bank in Pakistan was allowed to accept interest-bearing deposits and all existing deposits in a bank were labeled to be on the basis of profit and loss sharing. Foreign banks however, were exempted. The State Bank of Pakistan had specified 12 modes of non-interest financing classified in three broad categories (Report of State Bank of Pakistan, 2000).

The Federal Shariat Court (FSC), however, declared the procedure adopted by banks in Pakistan since July 1 1985 as un-Islamic. The court's original ruling, in 1999, clearly declared that all forms of interest charged during financial transactions fall into the category of *ribā*, which is forbidden in Islamic teachings and ordered the government to abolish interest charges.

A number of financial institutions warned the government that the new system was not viable and some of the foreign banks even hinted that

they might have to shut down their operations in the country. Hence, the government and some other financial institutions made appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan. The SAB delivered its judgement on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. In this judgement, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the *Shari'ah* (State Bank of Pakistan Annual Report FY02).

The Commission for the Transformation of the Financial System (CTFS) was constituted in January 2000 in the State Bank of Pakistan to prepare model agreements and financial instruments for the new system. Two interim reports by the CTFS were submitted in October 2000 and May 2001 respectively. The objective was to identify a number of prior actions to prepare the ground for transformation of the financial system and to identify major *Shari'ah* compliant modes of financing. The Commission submitted its final report to the government in August 2001.

According to the Commission, preparatory works for the introduction of a *Shari'ah* compliant financial system briefly included creating a legal infrastructure conducive to the working of an Islamic financial system, launching a massive education and training programme for bankers and their clients and an effective campaign through the media for the general public to create awareness about the Islamic financial system.

Meanwhile, the Shariat Appellate Bench (SAB) of the Supreme Court, in its short judgement dated June 24, 2002 set aside the previous verdicts on *ribā* by the Federal Shariat Court in 1991 and the verdict by the SAB in 1999 and referred the issue back to the Federal Shariat Court for a rehearing. The verdict is still awaited.

2.2 The performance of Islamic banks

A number of empirical studies revealed the profitable business of Islamic banks in different countries. The performance of Islamic banks has been judged by using different key ratios like profitability ratios, liquidity ratios, risk and solvency ratios (Sarker, 1999; Hassan and Samad, 1999). Iqbal (2001), for example, undertook trend analysis to depict the overall performance of Islamic banks as compared to conventional banks. According to him, Islamic banks in general are fairly stable, profitable and well capitalized. Their profitability ratios compare favourably with international standards in banking.

Alam (2000) undertook a case study to examine the contribution of Islamic Bank Bangladesh Limited (IBBL) towards a small and rural sector. The study revealed that IBBL succeeded in attracting both deposits and investment positions since it started its activities. For instance, the deposit figure rose to Taka 10,418 million in March 1995 from Taka 144.20 million as on March 1983, registering an increase of Taka 10,273 million. It was observed from the response of a few small-scale industrialists that the remarkable advantages they received from the bank included easy formalities for obtaining a loan and quick action in processing loan activities.

Samad and Hassan (1999) evaluated the performance of the Islamic bank in Malaysia in terms of its profitability, liquidity, risk and solvency. Financial ratios were applied to measure these performances. A comparison between the Islamic bank and eight other conventional banks was also made. The study revealed that the Islamic bank made significant progress on return on assets and return on equity during 1984-1997. The comparison of the Islamic bank and the group of eight conventional banks revealed that there was no difference in economic participation between them.

Sarker (1999) used the 'Banking Efficiency Model' to judge the performance of Islamic banking in Bangladesh. He concluded that Islamic banks could operate with a certain level of efficiency even within the presence of conventional banking.

Halim *et al.* (2001) conducted a study on the Malaysian Islamic Bank from the perspective of Islamic banking education. They showed that the shareholder's funds of the Islamic bank and the interest-free banking fund amounted to RM 1.3 billion, while profit before taxation and *zakāh* amounted to RM 153 million in 1997. The total financing of the Islamic bank registered a 39.6% increase in the second half of 1997.

Since the inception of the Profit and Loss Sharing (PLS) mode in the Pakistani banking sector, the volume of total deposits did not decline. Total PLS deposits of all scheduled banks increased from Rs.370,281 million to Rs.1,005,738 million in 1992 and 2001 respectively thus registering an average growth rate of 4% per annum (Table 1).

In light of these studies it could be argued that there is no question of the profitability, viability or efficiency of the Islamic banking system. Islamic banks are equally as profitable as any conventional bank. The basic issue is the implementation of Islamic banking in its true spirit.

Table 1: PLS Deposits in Scheduled Banks of Pakistan

Year	Total Deposits Rs. Million	Annual Growth
1992	370,281	--
1993	407,921	10%
1994	505,457	23%
1995	567,4409	12%
1996	633,701	11%
1997	690,182	8%
1998	743,923	8%
1999	821,297	10%
2000	931,991	13%
2001	1,005,738	8%

Source: State Bank of Pakistan (1998, 1999, 2000, 2001), *Statistical Bulletin*

2.3 An overview of impediments faced by Islamic banks in Asia

Many obstacles are realized in the implementation of Islamic banking in different countries. For instance, Sarker (1999) while mentioning the problems faced by the Islamic banks in Bangladesh lists 30 problems at macro level operations and 23 relating to the micro operation level. A few of such factors are: insufficient legal protection; lack of unified *Shari'ah* rulings; shortage of supportive and link institutions; shortage of skilled and trained manpower in Islamic *Shari'ah* banking.

At the micro operational level, Sarker (1999) states the following as being among 23 other problems: lack of a *Shari'ah* manual or guidelines; lack of linkages with other Islamic banks and Islamic NGOs for extending micro credit; lack of linkages with training institutes and *Shari'ah* supervisory bodies; lack of management's commitment in strictly following *Shari'ah* guidelines.

Khan (2001), while commenting on banking regulations and Islamic banks in India, recommends that the Islamic banks in India should diversify the instruments of investment and set up training institutes on Islamic banking that should impart training to borrowers and other members of the public. This would increase the clientele of the Islamic banks. Khan (2001) also suggests that the Islamic banks should earmark some funds to finance the poor and should provide them with job training so that they can create employment. Such practices are being successfully implemented in Tamil Nadu by English missionaries.

While giving the Malaysian experience in Islamic banking, Halim *et al.* (2001) stressed the importance of the educational system and its role

in developing an Islamic banking system. They drew attention towards the low awareness among the general public of the Islamic financial system and consider this to be one of the major factors hindering efforts towards the development of an Islamic banking system.

2.4 Factors affecting Islamic banking in Pakistan

In light of the literature review and with special reference to Pakistan, a number of factors have been taken into consideration in the questionnaire to analyze, in depth, the challenges and problems faced by the Islamic banking system. These are:

Legal framework: The legal framework and support impart a positive impact on the effective working of Islamic banking. The lack of legal support may hamper the Islamization process of banking. Sarker (1999) has pointed out insufficient legal protection as an important problem faced by the Islamic banks in Bangladesh.

Knowledge sharing: Sharing of knowledge is essential for developing a successful economic system as it is impossible for a single person or a small group of individuals to accumulate all the knowledge needed for designing such a system (Hayek, 1945). Presently, knowledge sharing on Islamic banking issues is very low, the countries working to develop the system are working almost in isolation. Hence, this factor is taken into account in the analysis.

Research and Development (R&D): The purpose of sharing knowledge (above) is basically to aid the R&D efforts in Islamic banking and to reduce expenses. R&D is essential for banks so that they can offer new services that are 'Shari'ah compliant' in spirit.

Public awareness: The public should be made aware of the cultural impact that an Islamic banking system would have. They should be educated on the social benefits that society would gain from adopting the system. Issues of poverty, basic public services in health, education etc., can be addressed by drawing strength from such a banking system.

Political resolve: Political resolve may be regarded as the most important issue from the followers of the democratic school of thought. Beer (1981) argues this as a result of his years of research on the Viable System Model (VSM) and Espejo and Harnden (1985) stress the role of strategic and policy issues in the working of any business system, as also for non-profit and government organizations. Political commitment and leadership are needed for developing the Islamic financial system and the allocation of

resources to substantiate the government's resolve needs to be placed at the top of the agenda.

III. Determining Strategic Directions

Strategic planning is long-term planning that focuses on organization as a whole, what must be done in the long term (three to five years) to attain organizational goals. The present study attempts to blend theoretical knowledge and field experiences to determine impediments in the development of Islamic banking and identify practical solutions to the problem. Incorporating the insight of policy makers in the banking community is extremely important for such a study. Based on experiences of developing an interest-free banking system in other countries as well as in Pakistan, a questionnaire was developed and vetted with experts to perceive the 'bankers' view' on some vital issues. As the investigation relates to policy matters, top management at presidential and vice presidential level, and some senior management of banks were interviewed.

The critical success factors identified are:

- (i) The Islamic spirit in the present Islamic banking system and its importance in developing a truly Islamic system
- (ii) Competitiveness of the present Islamic banking system and its importance in developing a future system
- (iii) The state of present 'supervisory and regulatory' systems in supporting Islamic banking in Pakistan and its importance in developing an Islamic banking system in the future.

3.1 Incorporating *CoP* insight

Insight on the issue from bankers *CoP* (Community of Practice) was obtained by interviewing the senior management of major national and international banks operating in the country. Interviews were conducted with thirty executives, selected randomly, assuming that top executives of banks are in a position to conceive of the constraints of implementing interest-free banking in the country.

Firstly, frequency distributions were made from the data collected by interview, and then strategy mapping via radial graphs was adopted to compare the present status of the selected factors and the importance attached to these factors by *CoP*. The gap between the present status and importance attached to these factors would indicate the area in which efforts are needed.

The perception of Banking *CoP* is given as Table 2 and Table 3. From Table 2 it is clear that 29% opined the Islamic banking highly competitive. The 'Islamic spirit' in the prevailing Islamic banking system was considered low by 32% of respondents. The status of the present supervisory and regulatory mechanism supporting Islamic banking was considered very low (*i.e.* inadequate) by almost 42% of respondents.

Table 2. Key Factors Regarding the Present Islamic Banking System in Pakistan

	Very Low	Low	Medium	High	Very High	Decline Answer
If we compare the Islamic banking system with interest based banking within Pakistan, how competitive is Islamic banking?	19.4%	25.8%	16.1%	29%	9.7%	0%
To what extent does the present Islamic system in Pakistan have 'Islamic spirit'?	29.0%	32.3%	16.1%	6.5%	6.5%	9.7%
To what extent is the present 'supervisory and regulatory' mechanism developed effective in supporting Islamic banking in Pakistan?	41.9%	19.4%	22.6%	9.7%	0%	6.5%

Table 3 shows the importance that *CoP* attaches to the key factors for developing an Islamic banking system. The table shows that 29% of respondents recommend that the Islamic banking system should be 'highly competitive' in an open economy. 39% recommend that there should be a 'very high' presence of 'Islamic spirit' in the Islamic system. The importance of the supervisory and regulatory mechanism was also 'highly' recommended by 42% of respondents.

Table 3. The Importance that must be Attached to Key Factors

	Very Low	Low	Medium	High	Very High	Decline Answer
Do you think that a true Islamic banking system would be competitive in the open market?	6.5%	9.7%	29%	25%	29%	0%
To what extent should a system that is to be labeled as an 'Islamic banking system' be true in Islamic spirit?	9.7%	6.5%	22.6%	19.4%	38.7%	3.2%
What importance do you give to the 'supervisory and regulatory' mechanism for Islamic banking in Pakistan?	9.7%	9.7%	6.5%	32.3%	41.9%	0%

Table 4 has two columns, where column 'A' displays the response of *CoP* to questions regarding the status of the present Islamic banking system working in the country and column 'B' displays the importance that *CoP* attaches to these factors for developing an Islamic banking system in the country. The idea is to determine the gap between the current system status and the recommended level.

3.2 Graphical representation

Radial diagrams present the data shown in Tables 2, 3, and 4. Radial diagrams enable us to view the issue in multiple-dimensions and are particularly useful for exploring strategic directions. It is assumed that respondents who marked in the 'very high' column fully agree with the question, that those who marked on 'high' are about 75% in agreement. Similarly, 'medium' and 'low' are 50% and 25% respectively in agreement with the question posed. An index is calculated on the aforementioned basis and graphs are plotted. The index always falls in the interval 0 to 1. (Annex 1)

Table 4. Factors Affecting the Development of an Islamic Banking System in Pakistan

Factors	'Column A' Present Status (%)*						'Column B' Importance that must be given to these factors (%)*					
	Very Low	Low	Medium	High	Very High	Decline Answer	Very low	Low	Medium	High	Very High	Decline Answer
Legal framework (at government level) for supporting Islamic banks	36	39	13	10	0	3	7	7	3	16	68	0
A system for <i>Shari'ah</i> audit in financial institutions	55	29	7	0	0	10	10	7	3	42	39	0
<i>Shari'ah</i> compliant government economic laws	55	32	0	0	3	10	7	7	23	13	52	0
Research and development in the field of Islamic finance and economics	36	32	29	0	0	3	10	3	7	16	65	0
Sharing of knowledge between Islamic banks at national and international level	45	32	16	0	0	7	7	7	3	23	61	0
Public awareness about the Islamic economic system	52	36	7	0	0	7	13	3	3	36	45	0
Social & cultural factors of the public	16	16	23	19	23	3	13	0	13	36	39	0
Political resolve of successive governments for Islamization of economy	55	32	3	7	0	3	19	0	3	26	52	0

Note: * This may not equal 100 due to a rounding effect.

Indices have been computed as:

$$Index = \frac{Y_0 + Y_1(0.75) + Y_2(0.50) + Y_3(0.25)}{cat}$$

where

Y_0 =number of respondents in the category who answered 'very high'; Y_1 =number of respondents in the category who answered 'high'; Y_2 =number of respondents in the category who answered 'medium'; Y_3 =number of respondents in the category who answered 'low'; and cat =number of respondents in the category.

Figure 1 provides a view on three issues (competitiveness, Islamic spirit and the supervisory system) in the present Islamic banking systems and *CoP* recommendations for the same three issues in one diagram, whereas Figure 2 considers eight issues relating to the Islamic banking system and the importance attached to these issues by *CoP* in the same diagram.

Figure 1 gives the *CoP* perception on critical factors from Table 1, regarding the Islamic banking system in Pakistan. It is observed that the present system focuses on competitiveness and viability but it is relatively weak on the supervisory mechanism and Islamic spirit. It is interesting to note that the greatest number of 'declined answers' by the respondents were on the issue of rating Islamic spirit in the prevailing banking system, 9.7% respondents preferred not to answer this question, followed by 6.5% declining to answer the question relating to the effectiveness of the supervisory and regulatory mechanism (see also Table 4).

Figure 1: Present Status and the Importance of Some Critical Success Factors for an Islamic Banking System

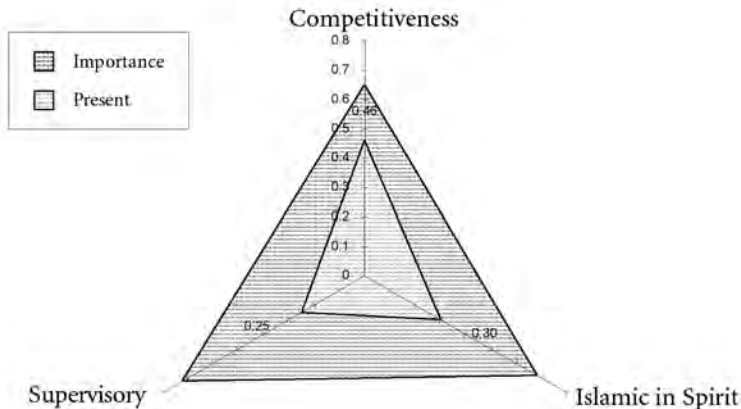
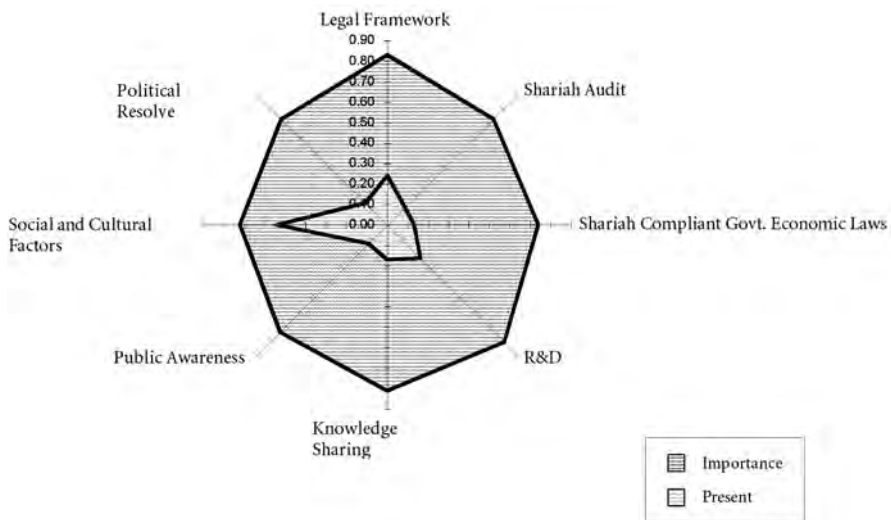


Figure 1 also displays the importance that CoP gives to these factors for developing Islamic banking. The highest importance is given to the need for a 'supervisory and regulatory mechanism' closely followed by 'competitiveness of the system'. The importance of Islamic spirit in banking laws is also identified as a vital success factor.

Figure 2 displays the status of the prevalent Islamic banking system in Pakistan and the importance that should be given to these factors for developing an Islamic banking system. It is evident that improvements are needed on all issues.

The prevailing system is rated lowest on *Shari'ah* related issues like '*Shari'ah* Audit' and '*Shari'ah* compliant government laws'. Sarker (1999) pointed out similar problems faced by the Islamic banks in Bangladesh.

Figure 2: The Importance and Present Status of Issues Relating to the Development of an Islamic Banking System



The present status of public awareness, the political resolve of successive governments and the sharing of knowledge between Islamic banks on a domestic as well as an international level is also rated low. Halim *et al.* (2001) emphasized the need to educate people about the Islamic financial system in Malaysia.

Another indication that can be derived from the responses is the 'gap' that has to be covered on these issues. This is indicated by the difference

between the present score for an issue and the importance calculated for that particular issue. Sorting response data firstly on 'importance' and then according to the 'gap, we see that bankers have identified the need for a 'legal framework' at the top followed by R&D and knowledge sharing. The 'Shari'ah compliance in government economic laws', and other issues closely follow a similar trend.

The views of management on 'social and cultural factors' are diverse. The index calculated indicates that social and cultural factors are not the actual barrier to implementing an Islamic banking system; rather, it is the low political resolve by governments that might be the real barrier.

IV. Conclusion and Policy Implications

A system is able to survive in an environment if it is able to maintain its distinguishing features and provide something that is useful to the environment in which it is working (Bear, 1979). On the basis of the results it is concluded that some of the key factors are a major obstacle in the implementation of the Islamic banking system in Pakistan.

This study proposes two recommendations at strategic level.

- (i) There is an urgent need for 'knowledge sharing' on an Islamic banking system within the countries working to develop such a system;
- (ii) Secondly the R&D effort, for developing new services, compliant with Islamic teachings, needs to be improved.

The following tactical initiatives are needed to achieve such strategic objectives:

International conferences on Islamic banking must be held frequently and with wider publicity, as this will provide scholars with a better opportunity to share their ideas and to gain from one another's insights.

Networking of scholars and bankers: Linkages should be developed between the research centres working on Islamic banking in different universities of the world and banking organizations. Research conducted by one university should be available to other universities. This would reduce R&D costs and at the same time quality of research would improve due to the wider audience.

Knowledge portal: Developments in ICT (Information & Communication Technology) have dramatically changed the working of organizations, connecting globally remote places into networked organizations. A central repository of knowledge on Islamic banking can help researchers and

scholars working in their native countries. Online collaboration software and discussion groups can also be used to create synergy in the efforts made by researchers in this field. Knowledge portals can provide grounds to develop a consensus in interpretation of the *Shari'ah* as it is applied to the banking system.

R&D to develop better services: Islamic banks would have to facilitate the requirements of a digital economy. This implies that individual banks would have to offer new services that are compliant with Islamic laws and at the same time fulfill the requirements of modern businesses. R&D would also be needed to improve harmony between Islamic banking laws and government legislation so that banks can perform properly. Bankers have given the highest priority to the need for developing a legal framework for Islamic banking and expressed their dissatisfaction with its present status. Considering the present state of the Islamic banking system, an effective legal framework for the system is possible only through extensive R&D by a combined effort of banking and *Shari'ah* experts.

Socially responsible investments: Islamic banks should invest in socially responsible projects only. When approving finances for a project the banks should scrutinize the social implications of the project. For example, the bank should ensure that the project will not cause any kind of environmental degradation in its vicinity or that proper wastage handling is incorporated into the project. HSE (Health, Safety & Environment) or social compliance must be ensured in the project. In short, organizations funded by Islamic banks should be concerned about the wellbeing of the society in which they are working.

Community oriented projects: Islamic banks should prefer to invest in community oriented projects, so that communities at large benefit from the workings of the bank. Projects designed to help the financially deprived must be financed as a matter of priority.

Educating bank personnel and society: The training of bank personnel and creating awareness among society about the true nature of Islamic banking is essential. The public should be made aware of the cultural impact that an Islamic banking system would have on them. Educational institutions may be helpful in spreading knowledge of the *Shari'ah* as well as principles of finance. Awareness programmes across the mass media and discussion forums would also help in informing public opinion on the issues.

Enhancing annual reports of the Islamic banks: A key recommendation is to enhance the presentation of the annual reports of Islamic banks. Annual reports are a strong media available to banks for communication. The annual report briefs bank stockholders on the performance of the institution and its future vision. Annual reports of Islamic banks should be different to the reports published by conventional banks. They should contain a vision of the bank as envisaged under Islamic principles. This approach will develop the confidence of the investors that their money is being invested according to the provisions of Islamic law.

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Appendix: Indices

Critical Factors	Present	Importance
Competitiveness	0.46	0.65
Islamic in Spirit	0.30	0.68
Supervisory	0.25	0.72

Issue	Present	Importance	Gap
Legal Framework	0.24	0.83	0.59
<i>Shari'ah</i> Audit	0.12	0.73	0.61
<i>Shari'ah</i> Compliant Govt. Economic Laws	0.13	0.74	0.61
R&D	0.23	0.81	0.58
Knowledge Sharing	0.17	0.81	0.64
Public Awareness	0.13	0.74	0.61
Social & Cultural Factors	0.54	0.72	0.18
Political Resolve	0.15	0.73	0.58