Securities and Exchange
Commission of Pakistan

SECP

A Diagnostic Review of ISLAMIC FINANCE in the Non-Bank Financial Sector of Pakistan

This diagnostic review explores issues and challenges in the Islamic financial services industry within the regulatory domain of SECP with the aim of providing a holistic approach for addressing the challenges for the organized development of Islamic finance in the Pakistan

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADB	Asian Development Bank
AMCs	Asset Management Companies
COMCEC	The Standing Committee for Economic and Commercial Cooperation
COP 26	United Nations Climate Change Convention
CII	Council of Islamic Ideology
CDC	Central Depository Company of Pakistan
CDNS	Central Directorate of National Savings
CEIF	Centre of Excellence for Islamic Finance
CMC	Collateral Management Company
CPIF	Chartered Professional in Islamic Finance
CSAA	Certified Shariah Advisor and Auditor
CIPA	Certified Islamic Professional Accountant
DIFD	Department for International Development
DMO	Public Debt Management Office
DFI	Development Finance Institutions
ETFs	Exchange Traded Funds
EWR	Electronic Warehousing Receipt
ESG	Environmental, Social, and Governance
FSC	Federal Shariat Court
FDI	Foreign Direct Investment
GoP	Government of Pakistan
GDP	Gross Domestic Product
IFD	Islamic Finance Department – SECP
IFAAS	Islamic Finance Advisory and Assurance Services
IFSB	Islamic Financial Services Board
HBFC	House Building Finance Company Limited
IILM	The International Islamic Liquidity Management Corporation
IsDB	Islamic Development Bank
ICAP	The Institute of Chartered Accountants of Pakistan
IAP	Insurance Association of Pakistan
ICP	The Investment Corporation of Pakistan
ICPs	Islamic Commercial Papers
IBIs	Islamic Banking Institutions
IFMP	The Institute of Financial Markets of Pakistan
IFSI	Islamic Financial Services Industry

LIST OF ABBREVIATIONS

IBA	Institute of Business Administration
KAP	Knowledge, Attitude and Practices
KIBOR	Karachi Interbank Offered Rate
KMI-30	KSE Meezan Index
MSF	Murabaha Share Financing
MoL	Ministry of Law and Justice
MoF	Ministry of Finance
MUFAP	Mutual Funds Association of Pakistan
NA	National Assembly of Pakistan
NBMFI	Non-banking microfinance institution
NBFCs	Non-banking finance companies
NCCPL	National Clearing Company of Pakistan Limited
NCMCL	Naymat Collateral Management Company Limited
NIT	National Investment Trust Limited
LUMS	Lahore University of Management Sciences
PSX	Pakistan Stock Exchange Limited
PBC	Pakistan Business Council
PBS	Pakistan Bureau of Statistics
PMEX	Pakistan Mercantile Exchange
PTC	Participation Term Certificate
PE	Private Equity
P2P	Peer-to-Peer
PIBs	Pakistan Investment Bonds
REITs	Real Estate Investment Trusts
Rs.	Pak Rupee
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SAB	Shariat Appellate Bench
SAC	Shariah Advisory Committee
SMEs	Small and Medium Enterprises
SPD	Special Primary Dealer
TA	Technical Assistance
T-bills	Treasury Bills
USSD	Unstructured Supplementary Service Data
VC	Venture Capital
Y-o-y	Year-on-year

PREAMBLE

1. In Pakistan, Islam is the state religion, and according to the Pakistan Bureau of Statistics, 98.28 percent of Pakistanis are Muslims. At the time of independence in 1947, the financial system of Pakistan as well as the underlying legal framework were inherited from the British India, having its roots in the laws of England (common law) at that time. After more than 75 years of independence, the financial system and many such adapted laws are in practice, and some other laws have been subsequently promulgated, still following the spirit of common law. However, the Constitution of Pakistan requires that all laws of the country be brought into conformity with the injunctions of Islam, and as stated in the Article 38(f) of the Constitution of the Islamic Republic of Pakistan, 1973 ("the Constitution"), “the State shall Eliminate “Riba” as early as possible”.[1] Further part IX of the Constitution enumerates the Islamic Provisions (articles 227 to 231).
2. It is manifested from this constitutional requirement that Pakistani laws, including business and commercial laws governing financial transactions, are also required to be brought into conformity with the injunctions of Islam. Similarly, products, services, and financial transactions practiced under these laws should also be Shariah compatible.
3. There is a huge demand for Islamic financial services in the country, as depicted in the Knowledge, Attitude and Practices (KAP) Study of Islamic Banking in Pakistan carried out by the State Bank of Pakistan (SBP) in collaboration with the Department for International Development (DIFD). The study states that the overall demand for Islamic banking and finance in Pakistan among the retail sector is approximately 95 percent and about 73 percent for businesses.[2] Further, 94.51 percent of the banked population (sample) believed in the prohibition of interest, and 88.41 percent considered that the contemporary practice of interest in banks is prohibited, whereas, over 98 percent of the unbanked population believed in the prohibition of interest and considered the interest charged and given by banks as prohibited. These statistics clearly demonstrate that there is significant demand for Islamic banking and finance amongst retail and business in Pakistan. In view of the constitutional requirement, people’s preference and genuine demand for Islamic financial services, it is pivotal to devise Shariah-compliant mechanisms for fulfilling the legitimate financial needs of businesses and individuals through the development of a formal Islamic financial sector.
4. The Securities and Exchange Commission of Pakistan (SECP), in line with its mandate, as entrusted to it under the SECP Act, 1997, is, therefore, making concerted efforts to facilitate the growth of Shariah-compliant financial products in the financial services market. The Chairman (SECP), while speaking at the World Islamic Finance Forum, 2022, articulated the following key goals of Islamic finance:
   (a) protection, circulation, and halal augmentation of wealth;
   (b) justice and fairness in return distribution;
   (c) promoting real economic activities; and
   (d) enhancement of societal well-being.
5. A solid foundation for the Islamization of the country's financial system has already been laid. There is now a need to shift the focus of Islamic finance development beyond banking in order to complete the country's Islamic finance ecosystem and make it capable of serving, supporting, and supplementing economic activities in a Shariah-compliant and sustainable manner.
6. The Islamic finance services industry in Pakistan is expected to continue its growth trajectory, driven by steadily rising public demand for Islamic financial products. The size of the Islamic finance services industry in Pakistan is estimated to have crossed USD 42 billion at end-1Q22.[3] The assets of Islamic finance industry in Pakistan have crossed the six-trillion mark to reach Rs 6,781 billion by the end of June,2022. The market share of Islamic banking assets and deposits in the overall banking industry was 19.5 percent and 20.5 percent, respectively, by the end of June 2022. While the overall banking industry's market share of financing by Islamic banking institutions increased to 27.2 percent by the end of June 2022 from 24 percent in June 2021.[4]
7. In the case of Islamic capital markets, as of June 30, 2022, there are 258 (49 percent) Shariah-compliant securities out of total of 530 listed securities at the Pakistan Stock Exchange (PSX), with a market capitalization of Rs. 4,643 billion (67 percent) out of a total market capitalization of Rs. 6,957 billion. Assets

1. https://na.gov.pk/uploads/documents/1549886415_632.pdf
2. https://www.sbp.org.pk/publications/kapstudy.pdf
3. https://www.fitchratings.com/research/islamic-finance/government-push-to-aid-pakistan-islamic-finance-growth-07-06-2022#:~:text=State%20Bank%20of%20Pakistan%20targets,577%20billion%20(USD32%20 billion).
4. https://www.sbp.org.pk/ibd/bulletin/2022/Jun.pdf

valuing Rs. 448.13 billion (35 percent) under management of mutual funds schemes, and Rs. 26.93 billion (64.7) percent under management of pension fund schemes are Shariah-compliant as of June 30, 2022.[5] Although, Sukuk market in Pakistan is relatively underdeveloped, but is getting considerable attention by the government and corporate sectors alike for raising funds. Issuance and listing of Pakistan Energy Sukuk-II (PES-II) of Rs. 200 billion in 2020 by Power Holding Limited (PHL) through book-building process which helped the Government in addressing the challenges for resolving circular debt in the country's power sector. It is also pertinent to mention that the PES-II issue was 1.7 times over-subscribed and the rate of return paid by PHL was very competitive and saved the Government significant financing cost due to the dedicated efforts by the SECP. The SECP regulated REIT sector, which had been largely inactive since 2015, has reinvigorated and shown very encouraging growth. As of June 30, 2022, the size of REITs was Rs. 98.344 billion, marking a growth of 81 percent over the previous year's growth. The Takaful sector in Pakistan is marking its ground in line with the increasing demand for the Shariah-compliant solutions for risk management. Takaful sector of Pakistan consists of 35 Takaful operators. This includes 6 dedicated Takaful operators and 29 window Takaful operators. The asset size of the takaful sector (dedicated and window) is Rs. 88.731 billion as of June 30, 2022. In terms of insurance premium, takaful market share is 13 percent of the total size of the insurance market as of December 31, 2021, as compared to 12 percent as of December 31, 2020.

8. In the recent as well as earlier judgements of the Federal Shariat Court of Pakistan (FSC)[6], it has been concluded that "Riba or interest is prohibited in Islam, including relating to banking transactions." Accordingly, the mounting breadth and depth of the Islamic finance services industry and new market developments necessitate a holistic approach to prudently tackle main challenges faced by the industry in order to realize its full potential in light of the judgement. As per the decision, the provisions of the different laws that contained the term "interest" within the meaning of Riba were declared repugnant to the Injunctions of Islam. Further, the FSC appreciated the initiatives undertaken by the SECP, including the establishment of the dedicated Islamic Finance Department at the SECP for the promotion of the Islamic capital market and enablement of the Takaful business through the Takaful Rules, 2012.
9. The SECP, with a vast regulatory mandate covering the capital market, insurance, non-banking finance companies, pension funds, and corporate sector, has several touchpoints for the Islamic finance. These include (a) Islamic institutions like Modarabas, takaful operators, Islamic NBFIs, Shariah-compliant businesses, and Shariah advisors, (b) Islamic instruments like Shariah-compliant securities, Sukuk, Islamic commercial papers (ICPs), and (c) Islamic collective investment schemes like Islamic mutual funds, Islamic exchange traded funds (ETFs), Shariah-compliant real estate investment trusts (REITs). Non-profit organizations are also being registered and governed in the area of social development in accordance with the provisions of the Companies Act, 2017.
10. Accordingly, the purpose of this diagnostic review is to investigate issues and challenges in the Islamic financial services industry within the regulatory domain of the SECP in order to provide a holistic approach to addressing the challenges for the organized development of Islamic finance in Pakistan. The diagnostic review establishes a plan and strategy for taking the Islamic finance services industry to the next level of growth and development. Along with ensuring a conducive legal and regulatory environment, it focuses on the Islamic finance services industry to look for innovative products based on the Shariah principles and rules to cater to unserved and underserved sectors, which are paramount for the growth of the country's economy. The role of various stakeholders in efficiently achieving objectives will be of pivotal importance in the implementation of the policy recommendations.

OBJECTIVES OF THE DIAGNOSTIC REVIEW

11. This diagnostic review, therefore, based on a self-assessment and consultative approach, aiming to achieve the following key objectives, -
    (a) Identify key issues and challenges hampering growth of Islamic finance;
    (b) Identify opportunities for development of Islamic finance in capital market, insurance industry and other non-bank financial sectors;

5. https://www.secp.gov.pk/document/sector-summary-june-2022/?wpdmdl=45219&refresh=636dda763b5121668143734
6. https://www.federalshariatcourt.gov.pk/Judgments/S-P%2030-L1991%20Riba%20Case-28.04.2022.pdf Faridi, Muhammad Zahir, Muhammad Ramzan Sheikh, and Maria Sajjad Khan. "Economic Growth in Pakistan–A Historic Perspective, Journal of Historical Studies Vol. VII. No. I (Jan-Jun 2021) PP 175-189 and Husain, Ishrat. "Economy of Pakistan: Past, present and future." IBA Karachi, Pakistan (2004).

(c) Support the development of Islamic finance in Pakistan in an inclusive and sustainable manner; and
(d) Develop a comprehensive and timebound action plan to implement the key recommendations.

12. Following four pillars of envisaged targets have been identified to focus under this diagnostic review, -
    (a) Accelerate the growth of Islamic finance in regulated sectors;
    (b) Achieve greater standardization in the Islamic financial industry;
    (c) Improve the quality of Islamic financial institutions' operations; and
    (d) Strengthen the legal and regulatory frameworks for Islamic finance.

METHODOLOGY FOR THE DIAGNOSTIC REVIEW

13. The methodology used for conducting this diagnostic review comprises the following steps, -
    (a) Taking stock of development of Islamic finance within SECP's regulated sectors;
    (b) Engaging wider stakeholders to identify key issues and challenges hampering development of Islamic finance;
    (c) Review of related international best practices;
    (d) Summarizing key recommendations in light of envisaged targets, as mentioned in the paragraph 12 above; and
    (e) Formulation of time-bound action plan to achieve the recommendations.
14. Another independent assessment is also being carried out, with assistance from the Asian Development Bank (ADB), under Technical Assistance (TA) No. 9453-REG for Islamic finance for inclusive growth. ADB has engaged an international consultant, namely Islamic Finance Advisory and Assurance Services (IFAAS), to assist SECP in revamping existing legal frameworks related to Islamic finance, Islamic financial products and instruments, and undertaking a capacity-building program. The outcome of engagement under the TA, particularly benchmarking with comparable international jurisdiction, will also supplement recommendations and action plan under the diagnostic review.

CHAPTER 1:
PAKISTAN'S VANTAGE GROUND

1.1: Overview of Pakistan

15. The Islamic Republic of Pakistan emerged as an independent sovereign state on 14th August 1947. Presently, Pakistan covers 796,095 square kilometers with a population of over 220 million. Since its inception, Pakistan's economy has shown periodic "boom-bust" growth cycles. The reasons for such volatile growth cycles include the wide-ranging economic challenges like shrinking fiscal space, exchange rate pressure, mounting current account deficit, inflation, energy sector bottlenecks, the absence of a supportive environment for the private sector, and political instability in the country, which also led to a huge increase in economic uncertainty. Despite all these challenges, Pakistan is considered as one of the emerging economies with huge upside potential for growth.
16. According to many researchers,[7] Pakistan faced a survival challenge at its inception. Pakistan had a predominantly agrarian economy; agriculture contributed 53 percent of GDP in 1947 and 53.2 percent of GDP in 1949–50. Pakistan had only Rs. 200 million worth of foreign exchange, and average per capita income was less than US$100 with savings and investment rates of just 2 percent and 4 percent, respectively, in 1949. The decade of the 1950s was labelled as the "era of industrialization and import substitution policy," the decade of the 1960s as the "era of rapid but uneven economic growth," the decade of the 1970s as the "era of nationalization and command economy," the decade of the 1980s as the "era of Islamic ideology," the decade of the 1990s as the "era of democratic order and uncertainty," the decade of the 2000s as the "era of economic liberalization and growth," and the decade of the 2010s as the "era of democracy and challenges."
17. Pakistan was one of the few developing countries that had achieved an average growth rate of over 5 percent over a four-decade period ending in 1988–89. Consequently, the incidence of poverty had declined from 40 percent to 18 percent by the end of the 1980s. The country slacked in the 1990s and began to slip in growth, exports, revenues, and development spending, getting entrapped in a deep morass of external and domestic indebtedness. As a result, the incidence of poverty rose from 18 percent in 1988–89 to 33 percent by the end of the 1990s. This was due to both fundamental structural and institutional problems as well as poor governance and frequent changes in political regimes.
18. Pakistan possesses great potential for strong economic growth as it has a considerable and large internal market supported by dynamic demographics. Further, with hefty foreign remittances from migrant workers, a large and inexpensive labour force, and the ongoing development of economic corridors with China and Central Asia, Pakistan is well positioned for rapid economic growth.

1.2: Key economic indicators of Pakistan

19. According to the Pakistan Economic Survey 2021–2022, the real GDP growth remained at 5.97 percent in fiscal year 2022 (FY2022). However, underlying macroeconomic imbalances and associated domestic and international risks have dampened celebrations. The economy of Pakistan rebounded from the pandemic (0.94 percent contraction in FY2020) and continued to post a V-shaped economic recovery, which is higher than the 5.74 percent recorded last year (FY2021). For FY2022, GDP at current market prices stands at Rs. 66,950 billion, showing a growth of 20.0 percent over last year (Rs. 55,796 billion). In the dollar term, it remained at US$ 383 billion. Regarding per capita income in terms of dollars, there was a rebound seen in FY2021 that continued in FY2022. In FY2022, per capita income was recorded at US$1,798. This reflects an improvement in prosperity due to the fact that economic growth per person improved.
20. During Jul-May FY2022, net federal revenues grew by 11.6 percent to Rs. 3,350 billion against Rs. 3,003 billion last year. On the other hand, total expenditure witnessed a sharp increase owing to a 33.1 percent growth in current spending. FY2022 tax collection surpassed the Rs. 6 trillion mark for the first time in its history. The fiscal year 2022 ended up by posting 29 percent growth with a net tax collection of Rs. 6,126 billion, compared to Rs. 4,745 billion in FY2021. During Jul-May FY2022, the fiscal deficit increased by 5.2

7. Faridi, Muhammad Zahir, Muhammad Ramzan Sheikh, and Maria Sajjad Khan. "Economic Growth in Pakistan–A Historic Perspective, Journal of Historical Studies Vol. VII. No. I (Jan-Jun 2021) PP 175-189 and Husain, Ishrat. "Economy of Pakistan: Past, present and future." IBA Karachi, Pakistan (2004).

percent (Rs. 3,468 billion) against 3.9 percent (Rs. 2,197 billion) in the comparable period of last year. Similarly, the primary balance posted a deficit of Rs. 945 billion (1.4 percent of GDP) in Jul-May FY2022 against the surplus of Rs. 139 billion (0.2 percent of GDP) last year. The current account posted a deficit of US$ 17.4 billion for FY2022 as against a deficit of US$ 2.8 billion last year. Exports on fob grew by 26.6 percent during FY2022 and reached US$ 32.5 billion (US$ 25.6 billion last year) whereas, imports on fob grew by 32.8 percent during FY2022 and reached US$ 72.0 billion (US$ 54.3 billion last year). Resultantly the trade deficit (FY2022) reached to US$ 39.6 billion as against US$ 28.6 billion last year. In FY2022, foreign remittances increased by 6.1 percent to US$ 31.2 billion (US$ 29.4 billion last year). In FY2022, FDI reached US$ 1867.8 million (US$ 1820.5 million last year) increased by 2.6 percent. During FY2022, inflation stood at 12.2 percent, compared to 8.9 percent in the same period last year. Rising food prices remained the primary driver followed by vehicle fuels and electricity charges. Whereas, CPI Inflation recorded at 21.3 percent in June 2022 as against 9.7 percent in same month last year.[8]

1.3: The financial landscape of Pakistan

21. Financial system plays a key role in fostering economic growth by efficiently channelizing the funds to investments. Financial sector development has been instrumental in accelerating economic growth by providing the deposit mobilization and payment services to the economy. The financial sector creates economies of scale by pooling the relatively small savings of a large number of individuals and making them available for relatively large investment. As per the World Bank[9], a growing body of evidence suggests that financial institutions (such as banks and insurance companies) and financial markets (including stock markets, bond markets, and derivative markets) exert a powerful influence on economic development, poverty alleviation, and economic stability. For example, when banks screen borrowers and identify firms with the most promising prospects, this is a key step that helps allocate resources, expand economic opportunities, and foster growth. When banks and securities markets mobilize savings from households to invest in promising projects, this is another crucial step in fostering economic development. When financial institutions monitor the use of investments and scrutinize managerial performance, this is an additional ingredient in boosting the efficiency of corporations and reducing waste and fraud by corporate insiders.
22. Like any other functioning economy, the financial system in Pakistan consists of financial institutions and financial markets. The financial institutions consist of banks and non-bank financial intermediaries. The banking intermediaries include commercial banks, Islamic banks, specialized banks, and microfinance banks, while the non-bank intermediaries include development finance institutions, non-bank financial institutions, and insurance companies. The financial markets include the money market, the stock market, the futures market, the market for bonds, both listed and unlisted, the derivatives market, both at the stock exchange and the futures exchange, as well as the over-the-counter market. The size of whole financial sector of Pakistan (in terms of assets) were reported as Rs. 39,230 billion at the end of calendar year 2021, representing 63.9 percent of GDP.[10]
23. The State Bank of Pakistan Act, 1956 mandated the SBP to regulate Pakistan's monetary and credit systems and foster their growth in the best national interest in order to secure monetary stability and fuller utilization of the country's productive resources. It is the SBP's duty, as a central bank, to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage. The SBP is also a regulatory body for the money market, where short-term debt instruments (with maturities less than one year) are traded, and it has been established for transactions in wholesale short term loans and deposits and for trading short-term financial instruments. SBP has also allowed a limited number of derivative products (swaps and options) to derivative market participants with certain reporting and disclosure obligations, and the market is only used for hedging purposes.
24. With hundreds of millions of people unbanked, nearly 3/4th of Pakistan's population is excluded from the financial system. Only 21 million adults have transactional accounts, of which only 7 percent are women, as compared to Southeast Asia and lower-middle income countries, whose averages are up to 53 percent and above.[11] According to the SBP's Payment Systems Review for the quarter ended March 31, 2022, there

8. https://www.finance.gov.pk/economic/economic_update_July_2022.pdf
9. Cihak, M., Demirgüç-Kunt, A., Feyen, E., & Levine, R. (2012). Benchmarking financial systems around the world. The World Bank.
10. https://www.sbp.org.pk/FSR/2021/Complete.pdf
11. Post-webinar paper, September 2020, Financial Services Industry Challenges and The Way Forward https://www.icap.org.pk/paib/pdf/FinancialServiceIndustryPaper-01.pdf

are 44 banks, 33 commercial banks, and 11 microfinance banks, operating in Pakistan through 16,788 branches serving 66 million and 85 million banking accounts and branchless banking accounts, respectively.

25. Banking sector, regulated by the SBP, assumes significant importance in the financial system of Pakistan. Total assets of the financial sector were reported as Rs. 39,230 billion at the end of calendar year 2021, representing 63.9 percent of GDP. These assets comprise 76.6 percent of assets held by banks, 9.9 percent by CDNS, 5.5 percent by insurance companies, 5.2 percent by non-bank financial institutions, and the rest, 2.9 percent, by development financial institutions and microfinance banks.[12] The size of unfunded saving schemes (net of prize bonds) as of June 30, 2022, was reported as Rs. 3,208 billion, which translates into 7 percent of total central government debt.
26. The SECP, established under the SECP Act, 1997, is regulator of non-bank financial markets and corporate sectors. Under the SECP Act, 1997 and several other administered legislations, the SECP regulates the capital market, the insurance industry, non-banking finance companies, and pension funds, apart from matters relating to the supervision and control of corporate entities and matters connected therewith or incidental thereto.
27. A total of 530 companies with accumulated paid up capital of Rs. 1,525.9 billion are listed on the Pakistan Stock Exchange, while the total market capitalization is Rs. 6,956.5 billion, as of June 30, 2022. Although the market capitalization has been reduced significantly over the last few years, it still amounts to about 23 percent of total banking assets in the country. During the period July 01, 2021, to June 30, 2022, various commodities futures contracts, including gold, crude oil, and US equity indices, worth Rs. 867 trillion were traded at Pakistan Mercantile Exchange Limited (PMEX), the only commodity futures exchange in the country. The aggregate asset size of non-banking finance companies was Rs. 2,171 billion as of June 30, 2022, posting a promising growth of 15.29 percent as compared to assets of Rs. 1,839 billion as of June 30, 2021. As of December, 2021, total assets of the insurance industry stood at Rs. 2,149 billion, compared to Rs. 1,987 billion as of December 31, 2020, showing an 8 percent increase in asset size. Apart from four capital market infrastructure institutions, the capital market and non-bank financial sector has 661 licenced intermediaries as of June 30, 2022. SECP has also registered 26,502 new companies during the year, bringing the total number of registered companies now to 172,234. The insurance industry has 51 companies as of June 30, 2022, including 39 general insurance companies, 11 life insurance companies, and 1 reinsurance company. The other licenced persons include 24 insurance brokers, 242 insurance surveying companies, and 370 authorized surveying officers.

1.4: The evolution of Islamic finance in Pakistan

28. The Islamic Republic of Pakistan was established in the name of Islam, allowing its citizens to practise Islam freely in their daily lives. All the constitutions of the country have incorporated, within their principles of policy, the elimination of "Riba" as an important objective of state policy. Quaid-e-Azam, the father of the nation, in his speech at the occasion of the inauguration of the SBP, expressed the desire for evolving an Islamic system of banking.
29. Islamic finance movement in Pakistan started alongside its creation in 1947. The preamble of the Constitution provided that the sovereignty over the entire universe belongs to Almighty Allah alone, and the authority to be exercised by the people of Pakistan within the limits prescribed by Him is a sacred trust, and that in Pakistan, the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah, and that the people of Pakistan are cognizant of their responsibility before Almighty Allah and men.
30. In Pakistan, Islamic banking and finance emerged as a response to both religious and economic needs. Although, the efforts for the economy wide elimination of Riba started in the 1970s, most of the significant and practical steps were taken in the early 1980s. The earliest efforts towards finding an alternative to the interest-based system could be found in a number of reports submitted by the Council of Islamic Ideology (CII). The CII submitted its final report, giving the details of the alternative system of abolishing interest and stating that the implementation of the proposals could make Pakistan's economy completely interest-free within two years.

12. Financial Stability Review – 2021 by State Bank of Pakistan. https://www.sbp.org.pk/FSR/2021/Complete.pdf

31. As summarised in the SBP's annual report for 2001-2002, the process of Islamizing Pakistan's banking and financial system began in 1977-78. Pakistan was one of the three countries in the world that had been trying to implement interest free banking at a comprehensive/national level. But as it was a mammoth task, the switchover plan was implemented in phases. The Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 was promulgated to allow the establishment of Modaraba companies and the flotation of Modarabas for raising risk capital. Amendments were also made to the Banking Companies Ordinance, 1962, to include the provision of bank finance through profit and loss sharing, markup in prices, leasing, and hire purchase.
32. The Islamization measures included the elimination of interest from the operations of specialized financial institutions, including HBFC, ICP, and NIT, in July 1979, and those of commercial banks from January 1981 to June 1985. The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980, to permit issuance of a new interest free instrument of corporate financing named the Participation Term Certificate (PTC).
33. The other Islamization measures[13] are summarized below:
    (a). On January 1, 1981, separate interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman) to mobilize deposits on a profit-and-loss sharing basis;
    (b). From July 1, 1982, banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the Shariah-compliant mode of financing, i.e. Musharakah;
    (c). As of April 1, 1985, all finances to all entities, including individuals, began to be made in one of the specified interest-free modes. From July 1, 1985, all commercial banking in Pak rupees was made interest-free. From that date, no bank in Pakistan was allowed to accept any interest-bearing deposits, and all existing deposits in a bank were to be treated on the basis of profit and loss sharing; and
    (d). At that time, two important areas were kept outside the purview of the interest-free financial system, mainly due to lack of research in these fields: government borrowings (both domestic and foreign) and foreign exchange.
34. The mid-80s attempt was a significant step in the evolution of the Islamic financial system in the Pakistan. Pragmatically, it was the most diverse and up-to-date model of Islamization of the economy compared to any other model currently being practised in any other jurisdiction around the world. The concrete efforts and steps undertaken in the 1980s to transform the interest-based economy into an Islamic economy were considered pioneering work in the Muslim world. This effort became significant reference material for other countries that undertook the path towards introduction and establishment of an Islamic financial system.
35. In the early 1990s, the whole exercise was challenged in the Federal Shariat Court (FSC), and the procedure adopted by banks in Pakistan since July 1, 1985, was declared un-Islamic by the FSC in November 1991. The system was largely based on the "mark-up" technique with or without 'buy-back arrangement." The FSC, in its judgement dated November 14, 1991, declared that various provisions of the laws repugnant to the injunctions of Islam would cease to have effect as of July 1, 1992.
36. The government and some banks and Development Finance Institutions (DFIs) preferred to appeal 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. However, the decision regarding the transformation of the whole system was set aside in a review petition by the Supreme Court of Pakistan and sent back to the FSC to start fresh hearings.
37. The matter has been concluded in the FSC and the SBP, SECP, and industry played their parts in the promotion and development of Islamic banking and finance in Pakistan, in parallel with the conventional financial system. Following is the summary of key initiatives in this regard, -
    (a). In December 2001, criteria for the establishment of Islamic banks were announced by the SBP, and Meezan Bank Limited obtained the license as Pakistan's First Islamic Commercial Bank;
    (b). Considering the need for a separate department to look after the regulation and promotion of the Islamic banking sector, the Islamic Banking Department (IBD) was established in the State Bank in September 2003;

13. https://www.sbp.org.pk/ibd/islamic-bkg-review-03-07.pdf

(c). In recognition of the need for the Takaful as a Shariah-compliant alternative to conventional insurance, Takaful Rules, 2005, were promulgated, which were replaced by the Takaful Rules, 2012, in July 2012;

(d). Cognizant of the fact that to strengthen the operations and Shariah compliance of the Modarabas, Shariah Audit and Shariah Compliance Mechanism, 2012 were issued by the SECP;

(e). Islamic mutual fund industry and Islamic pension funds start emerging as vibrant avenues of Shariah-compliant saving and investments;

(f). In recognition of the fact to develop and oversee the Islamic capital market and Non-banking finance companies, a dedicated Islamic Finance Department was established in SECP in February, 2015;

(g). For development of Shariah-compliant securities, Public Offering Regulations, 2017 and Sukuk (Privately Placed) Regulations 2017 were notified;

(h). The Companies Act, 2017, introduced the concept of the Shariah compliant company and specific provisions for the certification of Shariah-compliant companies and securities in addition to the Shariah disclosure requirements;

(i). In November, 2017, Shariah Advisors Regulations 2017 were issued with the objective to improve the quality and credence of Shariah advisory function, and to professionalize the Shariah advisory businesses; and

(j). In November, 2018, Shariah Governance Regulations 2018 were issued for the governance of Shariah-compliant companies, Shariah-compliant securities and Islamic financial institutions under SECP's regulatory ambit.

38. The FSC, through its historic judgement dated April 28, 2022, has held that the challenged laws or provisions of the laws have been declared to have no effect after June 1, 2022, while the entire economy has to be transformed by December 2027. While few banks have preferred an appeal against this judgement, the SBP has also sought guidance from the honorable Shariat Appellate Bench of the Supreme Court in terms of its implementation and practicalities involved.

CHAPTER 2:
AN OVERVIEW OF NON-BANK ISLAMIC FINANCE IN PAKISTAN

39. The SECP established for the beneficial regulation of the capital markets and the corporate sector under the authority of the SECP Act, 1997, is an independent body entrusted with powers delegated to it under the said Act, including overseeing a number of administered legislations. The SECP's regulated sectors contain a number of significant touch points for Islamic finance. The core responsibilities of SECP include creating legal and regulatory framework, facilitating the establishment and operation of institutions that support the financial market infrastructure, licensing and registering market intermediaries, and supervising and enforcing the compliance by a variety of laws, rules, and regulations. All of these activities are important for the growth and completeness of Pakistan's Islamic ecology.
40. The Islamic finance sector falls under the purview of the SECP's regulatory framework and consists of (a) Islamic institutions like Modarabas, Takaful operators, Islamic NBFIs, Shariah-compliant businesses, and Shariah advisors, (b) Islamic instruments like Shariah-compliant securities, Sukuk, Islamic commercial papers, Islamic mutual funds, Islamic Exchange Traded Funds (ETFs), Shariah-compliant real estate investment trusts (REITs). Non-profit organizations are also being registered and governed in the area of social development in accordance with the provisions of the Companies Act, 2017.
41. The main thrust of the FSC judgement dated April 28, 2022 is on banking and the regulated financial markets falling within the regulatory ambit of SECP have not been specifically touched upon, apparently because of non-challenge to laws administered by SECP. However, SECP's proactive regulatory approach in the past couple of years, has resulted in some notable outcomes worth highlighting, as given below:
    (a) Listing of Power holding limited energy Sukuk of Rs. 200 billion, a first through the PSX book building process;
    (b) The launch of the first-ever Shariah-compliant ETF;
    (c) The approval of the first-ever Shariah-compliant developmental REIT;
    (d) Revamping of commodity Murabahah platform at PMEX;
    (e) Active utilization of Murabaha share financing product at NCCPL;
    (f) Progress towards Islamic financing against electronic warehouse receipts;
    (g) Permission for a Takaful operator to test parametric crop insurance;
    (h) Licensing of two Shariah-compliant housing finance companies; and
    (i) Disbursement of over 43K subsidized loan by one Islamic NBMFC.

42. The following sections provide an overview of the current status of development of various non-bank financial sectors:

2.1 Islamic capital market

43. The capital market is a significant part of the financial system and there is enough empirical data to support its potential influence on financial stability. Economic growth is fuelled by the expansion of the capital markets, and there are close ties between these markets and innovation. Riskier projects and businesses, which are typically not financed by banking lending, depend heavily on capital markets. Governments can also raise money through the capital market in a more competitive manner from a variety of investment groups. Islamic finance has a decent foothold in the realm of the Islamic capital markets. The primary capital market is comparatively active because of the large number of Shariah-compliant issuances. The following contains comprehensive information:

2.1.1 Sovereign and quasi Sovereign Instruments

44. The Government of Pakistan[14] first entered the global Sukuk market in 2005 with the issuance of US$600 million Sukuk, while the domestic Sukuk programme was launched in 2008. According to the SBP data, till June 2022, the government has successfully issued Ijarah Sukuk amounting to Rs. 3.25 trillion in the around Rs. 1.5 trillion in the medium term. It is also exploring new concepts like asset-light structure, green Sukuk and sustainable Sukuk to increase the share of Shariah-compliant instruments in government securities by the end of 2022-23.
46. Pakistan Energy Sukuk-II (PES-II) of Rs. 200 billion, was issued in 2020 by Power Holding Limited (PHL), a public sector company owned entirely by the Ministry of Energy and the Government of Pakistan. The Sukuk aimed to help the government fulfil its financing requirements, including but not limited to the settlement of part of the prevailing circular debt related to the power sector, specifically the government-owned electricity generation companies (GENCOs) and electricity distribution companies (DISCOs). This was the second issuance of this series of Sukuk, bringing the total amount of Shariah-compliant energy Sukuk to approximately Rs. 400 billion. The transaction was structured for a period of ten years, with six monthly profit (rental) payments at a rate equal to 6 Month KIBOR -10 bps, as determined by the book-building process. The Sukuk offering was 1.7 times oversubscribed. The Sukuk issuance is a strong indicator of the viability and potential of Islamic finance and holds enormous promise for bringing significant agreements to the government for the economy's benefit. Additionally, it also enabled the government to switch from interest-based borrowing to financing that complies with Shariah, as required by Pakistan's constitution.

2.1.2 Tier-I and Tier-II capital instruments

47. Since 2016, the Islamic banks namely, Meezan Bank Limited, Dubai Islamic Bank Limited, Albaraka Bank (Pakistan) Limited and BankIslami Pakistan Limited have issued 11 Tier-I and Tier-II capital instruments valuing Rs.45.74 billion (one issue after June 30, 2022). These instruments have not only enabled the Islamic banks to meet minimum equity and capital adequacy requirements of the SBP, but also created an attractive investment avenue for the institutional as well as retail investors (in case of listings).

2.1.3 Corporate Sukuks - Listed and privately placed

48. The SECP has issued 39 certificates of Shariah-compliant securities to multiple issuers (Islamic commercial papers and Sukuks) worth Rs. 406.94 billion till June 30, 2022, under the Shariah Governance Regulations, 2018 since its promulgation. There has been an increasing trend to issue short-term Sukuk for Shariah-compliant resource mobilization by corporations to fund working capital requirements. The standardized and swift process is helping issuers to regularly issue privately placed Shariah-compliant instruments reaching the number to 45 and 6 listed Sukuk as on October 31, 2022. A healthy growth in the segment is expected with the development of an Islamic capital market for redeemable instruments as an alternative to the conventional debt market. The institutional investors, particularly Modarabas, Takaful operators, Islamic debt mutual funds, retirement schemes, and individual investors, along with the Islamic banks, are expected to grow their investment portfolios with the development of these segments.

2.1.4 Collectives investment schemes

49. Islamic mutual funds operate similarly to conventional funds, with the exception that they exclusively invest in investments that adhere to Shariah principles and rules. As of June 30, 2022, 110 mutual funds managing assets valued at Rs. 448.13 billion are classified as Shariah-compliant, and they constitute 35 percent and 38 percent of the total mutual fund industry of Pakistan, in terms of size and number, respectively.
50. Although there is significant increase in trend of total assets mutual funds both by the conventional and Shariah-compliant assets but at the same time, there is decreasing trend in shares of Shariah-compliant assets with respect to conventional shares in the mutual funds sector. The same is shown in the following figures:

14. https://www.dawn.com/news/amp/1708430

Figure 1: A comparison of conventional vs Shariah compliant mutual funds

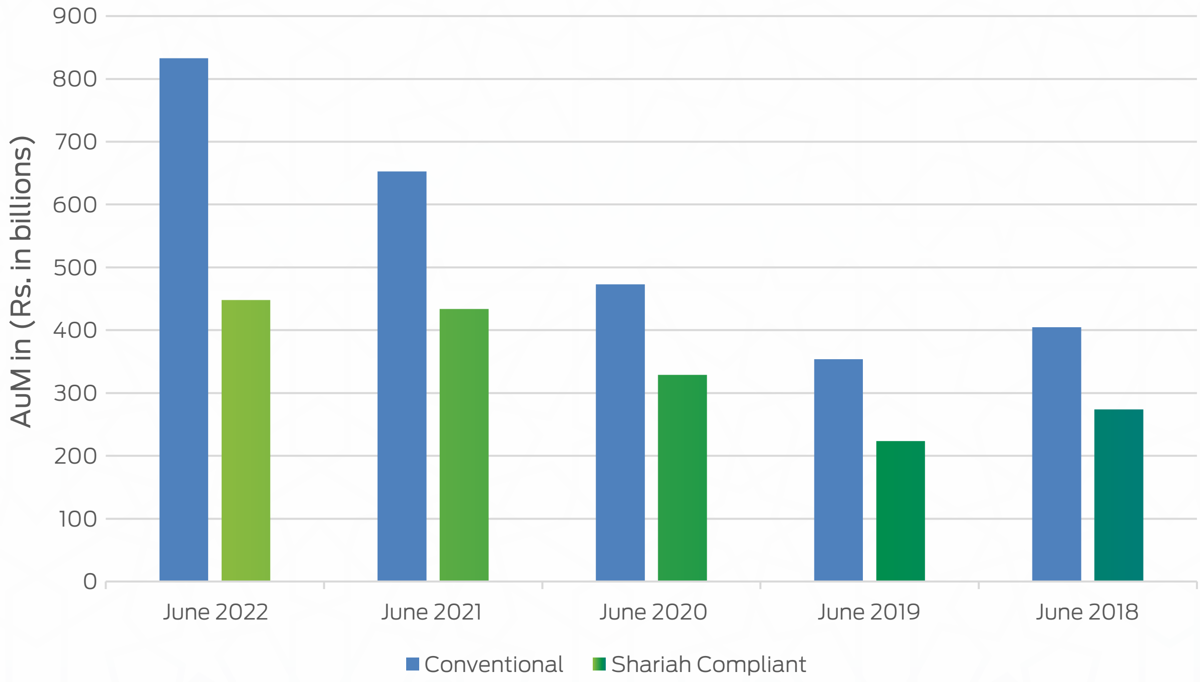
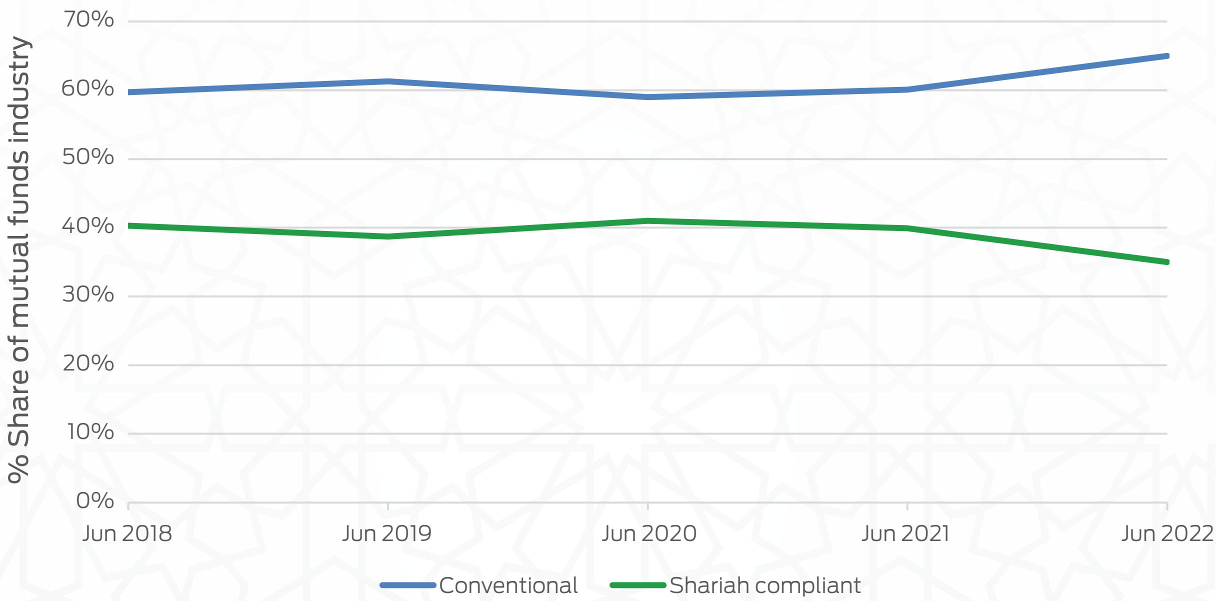


Figure 1: A comparison of share conventional vs Shariah compliant mutual funds



51. Islamic pension funds, under the voluntary pension fund schemes, are another important player in Islamic capital market. As of June 30, 2022, 12 pension funds managing assets valuing Rs. 26.93 billion are classified as Shariah-compliant and they constitute 64.7 percent and 54.6 percent of the total pension funds industry of Pakistan, in terms of size and numbers, respectively.
52. Another type of Shariah-compliant collective investment vehicle is Islamic REITs. After the launch of the first REIT scheme, namely Dolmen City REIT listed at PSX, this segment remained stagnant for a few years. However, collective efforts led by SECP have started to bear fruit, and now this segment is witnessing a growing interest from a wider stakeholder group. Out of the three privately placed REIT schemes until June 30, 2022, two of them were Shariah-compliant. Out of the total size of Rs. 86.51 billion of the four REIT schemes, the three Shariah-compliant REITs are worth Rs. 68.16 billion, which constitutes almost 79 percent of the total industry.
53. Another important area in collective investment schemes is private fund management. Private equity and venture capital (PE & VC) investment is poised to take off in Pakistan. There are five PE and VC funds and eight private equity companies operating in Pakistan. The total asset size of the PE and VC funds stood at Rs. 10.96 billion as of June 30, 2022, compared to Rs. 6.69 billion as of June 30, 2021, registering a growth of 38.96 percent. Currently, this segment is not being segregated into Shariah-compliant and non-Shariah-compliant due to its nascent stage; however, given the potential of this segment, it will be one of the key Shariah-compliant vehicles to mobilize resources to fund SMEs and innovative businesses.

2.1.5 Secondary capital market

54. In secondary capital market, there are 258 (49 percent) Shariah-compliant securities out of total 530 listed securities at PSX with market capitalization of Rs. 4,643 billion (67 percent) out of total market capitalization of Rs. 6,957 billion (as of June 30, 2022).
55. PSX has three Islamic indices namely KMI-All Shares, KMI-30 and MZNPI (Meezan Pakistan Index) that comprise of total 247, 30 and 12 underlying Shariah-compliant securities respectively (as on June 30, 2022). A total trading turnover of Rs. 34.7 billion shares, 13.1 billion shares and 6.2 billion shares respectively were recorded during the year 2021-22 that translate into 47.7 percent, 18.1 percent and 8.5 percent respectively of total trading volume at the PSX. Similarly, trading value of Rs. 1,388 billion, Rs. 917 billion and Rs. 517 billion respectively was recorded during the year 2021-22 that translate into 57.6 percent, 38.0 percent and 21.5 percent of total trading trade value at PSX.
56. Apart from trading activity, the National Clearing Company of Pakistan Limited (NCCPL) operates a platform for Murabaha share financing (MSF). MSF is a Shariah-compliant product that provides investors with an interest-free financing option for capital market investments. The product has been introduced in strict compliance with Islamic laws in the country after seeking approval from SECP. It is envisaged that MSF will provide a positive avenue for investors to diversify their portfolios, especially for those who want to invest through Shariah-compliant modes of finance. Since its activation in January 2022, NCCPL has provided financing to the tune of Rs. 1.07 billion to 20 investors. NCCPL serves 279,522 registered investors (UINs), 205 broker clearing members, and 212 non-broker clearing members.
57. The Central Depository Company of Pakistan Limited currently holds 120 Shariah-compliant securities (these include ICPs, Sukuk, Modaraba certificates, Modaraba instruments, etc. It also includes Islamic units offered by mutual funds declared CDS-eligible.) There are 876 issuers in the CDC that constitute 11.3 percent of Shariah-compliant securities out of the total number of securities available in the central depository system. Similarly, as of June 30, 2022, the market value of these securities is recorded at Rs. 789.91 billion, which constitutes 15.79 percent of the value of Shariah-compliant securities among total securities in the central depository system. There are also 309,032 individual and corporate account holders, 71,804 individual and corporate account holders, 649 total account holders, and 94 total pledgees.
58. Another significant capital market infrastructure institution is PMEX. It provides a platform for futures trading, a commodities Murabaha platform, and makes electronic warehousing receipts easier. Although, the Futures Market Act, 2016[15] provides the SECP the authority to make regulations outlining the requirements for

15. Clause (xxxi), sub-section (2) of section 114 of the Futures Market Act, 2016

trading Shariah-compliant contracts on the futures market, no such regulations have been put in place because the idea of a Shariah-compliant futures contract is still up for discussion. As a result, there is no futures market that complies with Shariah principles and rules.

59. The Shariah-compliant commodity Murabaha platform structure, which PMEX created and successfully implemented, is now inactive because Hascol Petroleum no longer participates in the service. However, efforts are underway to reactive this platform to facilitate Islamic financial institutions' liquidity management through a regulated platform.

60. Naymat Collateral Management Company Limited (NCMCL) was registered by SECP as the first CMC after the Collateral Management Company (CMC) Regulations 2019 were promulgated. When NCMCL issued the first Electronic Warehousing Receipt (EWR) in March 2021, the system became operational. As of now, NCMCL has licensed five warehouses for the storage of commodities, and other banks have also joined the EWR regime. The following commodities' EWR-based futures contracts have had their contract parameters authorized by SECP for trading on PMEX:
    (a) Yellow maize
    (b) Super basmati paddy
    (c) Long grain paddy
    (d) Super basmati milled raw rice
    (e) Super basmati brown raw rice
    (f) Long grain milled raw rice
    (g) Dry dates

61. The information below relates to the EWRs that NCMCL granted between July 1, 2021 to June 30, 2022.

Description	Details
Number of EWRs issued	894
Number of EWRs pledged	671
Quantity of total pledged commodity (MT)	16,081
Approx. value of total pledged commodity (Rs.)	643.1 million
Total Quantity of commodity (MT)	20,197
Approx. value of commodity (Rs.)	993.2 million

62. The EWR hold promise for the creation of Shariah-compliant goods in both the non-bank and Islamic banking industries.

2.2 Modarabas and other NBFCs:

63. Modarabas are unique collective investment vehicles, and since the 1980s, Modaraba has been a specialised industry dedicated solely to Islamic financial services. The Modaraba sector, in particular, has the ability to play an important role in serving SME financial needs and collaborating with other ventures as partners. The sector expected to rethink its business plan and look for new business opportunities now that the tax exemption has been removed. It's critical that the industry keeps up with the changes and expands its reach through technologically advanced products and services.

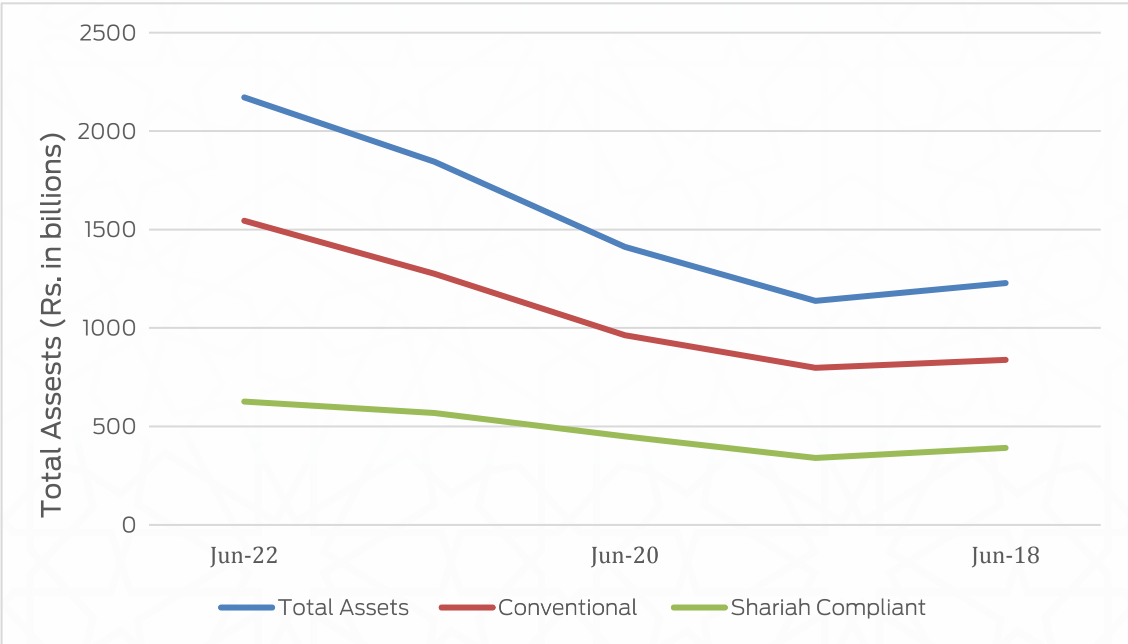
64. As of June 30, 2022, the equity of the Modaraba sector stood at Rs. 25.38 billion, whereas the total assets of the Modaraba sector amounted to Rs. 61.46 billion. Out of total twenty-two (22) profit making Modarabas, eleven (11) Modarabas declared a cash dividend for the financial year 2022. As of date, the registered Modaraba companies are thirty-one (31) while twenty-eight (28) Modarabas are currently operating and are listed at PSX.

65. Similarly, tens of circulars and directives were issued during the last two decades for the regulation of

Modaraba sector. Over time, the provisions of these circulars became obsolete, irrelevant, and sometimes contradictory. These circulars were reviewed and consolidated into a single document which was notified vide S.R.O.2310(I)/2022 and previous circulars were replead.

66. During the current year, the total assets of NBFI Industry were recorded at Rs. 2,171.21 billion by end of June 30, 2022 exhibiting an annual growth of 15.07 percent (Rs. 332.3 billion). Among them, the Shariah-compliant share of the assets was Rs.626.46 billion which comprises 28.9 percent of the total assets of the NBFI Industry reduced by 1.9 percent i.e. from 30.8 percent in 2021 to 28.9 percent in 2022 respectively. The growth in NBFI and share of Shariah-compliant assets since 2016 are as under:

Figure 3: Breakup of conventional and Shariah compliant assets of NBFI industry during last five years



67. Breakup of assets of conventional and Shariah-compliant analysis of assets of NBFI Industry by division among conventional and Shariah-compliant reflects that the assets of conventional expanded by 17.41 percent (Rs. 269 billion) during the period under review and stood at Rs. 1,544 billion by the end of June 2022. Similarly, assets of Shariah-compliant revealed a growth of 9.23 percent (Rs. 568 billion) and touched Rs. 629.46 billion by the end of June 2022. In terms of share, conventional and Shariah-compliant accounted for 71.2 percent and 28.9 percent share, respectively in overall assets of NBFI industry by the end of June 2022.

2.3 Takaful market:

68. The majority of Shariah experts are of the view that the conventional insurance is forbidden because it involves Riba (interest, usury, or any other kind), Qimar (gambling), Gharar (speculation), and assistance from industries that violate Shariah law (e.g. drugs and alcohol, tobacco, pork related items etc.). The concept of social solidarity, cooperation, and mutual indemnity of member losses serves as the cornerstone of Takaful, the Islamic equivalent of insurance. Takaful contracts are a viable substitute for traditional insurance because they offer Shariah-compliant coverage for many of the same things. Takaful companies exclusively engage in business that complies with Shariah, and the earnings are dispersed in line with the pre-agreed ratios in the Takaful agreement.

69. The Insurance Ordinance, 2000 defines the enabling legal and regulatory framework for takaful in Pakistan. In 2005, the Takaful Rules, 2005, were promulgated, which were subsequently replaced by the Takaful Rules, 2012, covering areas of Shariah compliance, market development, authorization, and financial soundness.

70. Takaful sector of Pakistan consists of 31 active operators. This includes 3 dedicated Takaful operators and 28 window Takaful operators. The asset size of the Takaful sector (dedicated & window) is Rs. 88.731 billion as of June 30, 2022. In terms of insurance premium, Takaful market share is 13 percent of total size of insurance market as of December 31, 2021 as compared to 12 percent in at December 31, 2020.

2.4 SECP's approach for development of Islamic finance in non-bank financial sector

71. Since July 2022, SECP has started implanting its new strategy for development of Islamic finance in non-bank financial sectors. In accordance with the Constitution, the goal is to complete the Islamic finance ecosystem in Pakistan in order to revitalise the true potential of Islamic finance for fostering economic growth and development. The approach is to involve wider stakeholders to document, through a diagnostic report, key issues, challenges, and bottlenecks hampering the development of Islamic finance in the non-bank financial sector, explore options, and develop a time-bound action plan to address those issues and challenges.
72. In order to optimise the institutional structure within SECP, the Islamic Finance Department and the Modaraba Wing, have been assigned to a single head of department since July 01, 2022. This will help in achieving consistency in the regulatory approach and developing a synchronized reform agenda.
73. In July 2022, the SECP has reconstituted its Shariah Advisory Committee (SAC) under the SECP Act, 1997. The SAC has been mandated to assist SECP in approving Shariah-compliant issues and guidance for the promotion of Islamic finance within the regulatory ambit of SECP. SAC has been further mandated to perform functions under rule 25 of the Takaful Rules, 2012. The SAC is now chaired by prominent scholar Dr. Mufti Irshad Ahmed Aijaz, who is also serving as Chairman of SBP's Shariah committee and is a member of the Religious Board for Modarabas. Other members included Mr. Omar Mustafa Ansari, who is a renowned chartered accountant by profession and is presently serving as Secretary General of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Mufti Ehsan Waquar is the third member of SAC, having contemporary qualifications in diverse disciplines apart from the religious qualifications. He is serving as Chairman of the Shariah Boards of National Bank of Pakistan and Soneri Bank Limited. The Head of the IFD of SECP will serve as an ex-officio member.
74. Apart from the reconstitution of SAC, the SECP also formed a consultation committee to assist in the preparation of the Islamic finance development plan and future roadmap through empirical work, studies, and industry collaboration. The consultation committee has been mandated to prepare a recommendatory report on the capital markets, the insurance industry, and other non-bank financial sectors. Dr. Irum Saba, an associate professor at IBA and a globally recognised leading professional in the field of Islamic finance, leads the consultation committee. Other members of the consultation committee include senior representatives of Islamic asset management, Islamic banks, Modaraba, the capital market, and academia. The chairperson of the committee has been authorised to invite participation from industry while formulating recommendations.
75. Furthermore, the SECP has also designated its officers as "Islamic finance champions" in all its policy functions. They are serving as focal points for concerted and coordinated efforts across the regulated sectors of SECP.
76. A series of consultative meetings are also being arranged with all stakeholders, including capital market infrastructure institutions, industry associations, registered Shariah advisors, issuers of Shariah-compliant securities, the Islamic banking department of SBP, leading professionals and academic leaders in Islamic finance. The feedback received in these meetings has helped in shaping this diagnostic report, listing key issues and challenges and framing recommendations. The valuable contributions by these stakeholders are acknowledged and well appreciated.
77. For an independent assessment, ADB, under a technical assistance for Islamic finance, has engaged IFAAS, as consultant, to perform a diagnostic review of the Islamic financial sector under the regulatory domain of SECP and provide an Islamic capital market development plan. This scope of activities being carried out by

IFAAS included the following:

a. Assistance in formulation of a future roadmap for further development of Islamic capital market in Pakistan, inter alia, covering the following, -
   - Conducting a gap analysis study for existing market against international jurisdictions concerning Islamic financial industry, with specific focus on Shariah compliance and Shariah audit.
   - Consolidating all existing frameworks related to Islamic finance under a “one-stop-window”.
   - Developing new products for issuers and investors, such as instruments and low-risk Musharaka and Mudarabah schemes, micro-Takaful products (Taktech-Takaful technology) for the SMEs and low-income segment of the society, through the use of Islamic micro and other fintech solutions.
   - Introducing regulatory framework for enabling green, brown, yellow Sukuks and asset light Sukuk issuances in Pakistan.
b. Supporting capacity building initiatives and creating awareness, covering the following, -
   - Sponsoring officers from SECP’s Islamic finance team to acquire professional qualifications such as CPIF, CSAA, CIPA, etc and participate in the international trainings.
   - Sponsoring an international conference on Islamic capital market to be arranged by SECP.
   - Arranging executive experience-sharing webinars/trainings by Islamic finance global professionals to assist stakeholders across the country, drawing on practical and relevant lessons in their specific context and unique working conditions.
   - Conducting advance level workshops for the industry, particularly in areas of Shariah audit, Shariah governance, All-Share Islamic Index at PSX, etc.
   - Capacitating Modarabas, Islamic NBFIs and SMEs in Islamic finance by providing simplified capacity building and awareness workshops to trainers (train-the-trainer program).

78. In spite of major development and growth in the Islamic financial sector over the last few years, there is still huge potential that remains to be tapped. The high potential areas are Islamic micro-takaful, financial access to SMEs through the Modaraba sector, the raising of funds through Islamic financial instruments like Sukuk, and the development of other new products.

CHAPTER 3:
GLOBAL ISLAMIC FINANCE LANDSCAPE

3.1: Islamic finance global bodies

79. Islamic finance has emerged as an effective tool for financing development worldwide, including in non-Muslim countries. Major financial markets are discovering solid evidence that Islamic finance has already been mainstreamed within the global financial system – and that it has the potential to help the challenges of ending extreme poverty and boosting shared prosperity. The role of global Islamic finance bodies in the promotion and development of Islamic finance is of paramount importance. These global institutions are working in the areas of standardization, policy making, product development, sectoral growth and financial inclusion.

3.1.1 Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI")

80. AAOIFI, based in Bahrain, is the leading international standard setting body for development and issuance of standards for the global Islamic finance industry. AAOIFI is entrusted to ensure the soundness and stability of the Islamic financial services industry including banking, capital market and insurance/Takaful in accordance to Shariah as well providing the guidance for regulatory and supervisory bodies. AAOIFI has footprints in around 37 countries having 150 institutional members – including central banks, Islamic financial institutions and other participants of the international Islamic finance industry.[16]

81. AAOIFI has promulgated more than 100 standards in the area of Shariah, accounting, auditing, governance, ethics and for Islamic financial institutions and Islamic finance transactions and structures, including Waqf and other ancillary institutions, with an aim to achieve progressive degree of harmonization in the international Islamic finance practices. Status of adoption of AAOIFI standards globally is tabulated below[17]:

Table 1: AAOIFI standards adoption globally

Level of AAOIFI standards adoption	No. of regulatory Jurisdictions			No. of countries		
	SHA	ACC	GOV	SHA	ACC	GOV
Full adoption	19	24	18	16	18	15
Partial adoption	4	5	6	3	5	6
Guidance/reference material	9	7	8	9	7	8
Local standards based on AAOIFI standards	2	4	4	2	4	3
Guidance & local standards based on AAOIFI standards	1	2	3	1	1	2
Supplementary reporting	0	1	1	0	1	1

**(SHA – AAOIFI Shariah Standards, ACC – AAOIFI Accounting Standards, GOV – AAOIFI Governance / Auditing Standard)*

16. http://aaoifi.com/foot-print-report-download/?lang=en | 17. http://aaoifi.com/foot-print-report-download/?lang=en

3.1.2 The Islamic Financial Services Board ("IFSB")[18]

82. IFSB is based in Kuala Lumpur and started its operations on March 10, 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. As at June 2022, the 188 members of the IFSB comprise 81 regulatory and supervisory authorities, 10 international inter-governmental organisations, and 97 market players (financial institutions, professional firms, industry associations and stock exchanges) operating in 57 jurisdictions.
83. Since its inception, the IFSB has issued thirty-six standards, guiding principles and technical notes for the Islamic financial services industry. The published documents addressing three Islamic finance sectors, including Islamic banking, Takaful and Islamic capital markets, highlights details on related sectors and objectives of issued standards.

3.1.3 The Islamic Development Bank ("IsDB/the Bank")[19]

84. The Islamic Development Bank is a multilateral development bank, working to improve the lives by promoting social and economic development in member countries and Muslim communities worldwide, delivering impact at scale, provide the infrastructure to enable people to lead better lives and achieve their full potential. The bank collaborates on partnerships between communities and nations, across 57-member nations bringing together the public and private sectors as well as with civil societies and the development sector through public private partnerships and other joint projects, such as the IsDB/Gates Foundation Lives and Livelihoods Fund.

3.1.4 The Standing Committee for Economic and Commercial Cooperation of the Organization of the Islamic Cooperation ("COMCEC")[20]

85. The COMCEC is the main multilateral economic and commercial cooperation platform in the Islamic world. COMCEC serves as a central forum to address the common development problems of the Islamic ummah and provide solutions to them. COMCEC has 57-member countries as well as 5 observer countries, which are spread over four continents. The main objective of the COMCEC is to address the economic challenges facing the Islamic ummah and to strengthen economic and commercial cooperation among the member states. Promotion of Islamic finance is one of the key areas of work at COMCEC.

3.1.5 The International Islamic Liquidity Management Corporation (IILM)[21]

86. The IILM is an international organisation established by central banks and a multilateral organisation to create and issue Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. Established in 2010 and headquartered in Kuala Lumpur, Malaysia, the IILM aims to enhance cross-border investment flows, international linkages, and financial stability by creating more liquid Shariah-compliant financial instruments for institutions offering Islamic financial services.
87. The IILM was designed to be ahead of the curve and support Islamic banks in the event of a liquidity crisis and potentially provide options to institutions offering Islamic financial services to have access to highly-rated liquidity instruments. The main objective of the IILM is to provide platform for the Sukuk issuance, since 2013 till now, Sukuk worth US$ 84.63 billion have been Issued. Further, Sukuk supply has reached $726.8 billion in the first six months of 2022, and is projected to increase to $742.3 billion by the end of the year 2022. The size of the Sukuk market is expected to reach $1.1 trillion in 2027, growing at a CAGR of 7.9 percent.[22]

3.2: Islamic finance global leaders

88. As per the Islamic Finance Development Indicator Saudi Arabia is the leading most developed country in Islamic finance followed by Malaysia, Indonesia, Bahrain and UAE.[23]
89. As per the IFSB stability report, 2022, global Islamic financial services industry (IFSI) assets grew by 11.3 percent (y-o-y) with a total worth estimated at US$ 3.06 trillion (2021).[24] The projected sense of optimism for further growth in 2022 is expected to be impacted by a number of headwinds and tailwinds given below in the Table 2:

18. https://www.ifsb.org/background.php
19. https://www.isdb.org/
20. https://www.comcec.org/
21. https://iilm.com/about-iilm/
22. https://www.arabnews.com/node/2156041/business-economy
23. https://icd-ps.org/uploads/files/ICD-Refinitiv%20IFDI%20Report %2020201607502893_2100.pdf
24. https://www.ifsb.org/psifi_05.php

Table 2: Headwinds and Tailwinds

HEADWINDS	TAILWINDS
Spillover of effect of financial tightening in advanced economies	Reopening and recovery of many economies
Rising oil and commodity prices amid inflation concerns	Increased digitalization
Exchange rate volatility	Increased sustainability-linked investments
Financial stability risk	Increased mergers and acquisitions

90. With footprints in over 57 jurisdictions, the current global volume of Islamic finance is valued US$ 3.06 trillion (2021) with the asset's growth of 11.3 percent (y-o-y) The projected total asset value for the global Islamic finance markets will amount to US$ 3.69 trillion by 2024.[25] Saudi Arabia, Malaysia, and Iran figure as the leaders in Islamic finance, contributing a major share of the world's Islamic financial assets. Malaysia, Iran, and the GCC region hold approximately 85 percent of the global Islamic banking and financial assets. However, the significance of Islamic finance is acknowledged worldwide, including in European and non-Muslim countries, which are striving to capture a piece of the pie. The contribution by the global Islamic finance bodies can never be undermined in the development of Islamic finance globally.

91. In 2021, the global IFSI demonstrated resilience, complemented various COVID-19 policy support measures, supported economies, and sustained its growth momentum despite a resurgence in the COVID-19 pandemic. The global IFSI is estimated to be worth US$ 3.06 trillion in 2021, marking a growth of 11.3 percent year-on-year (y-o-y) in assets in USD terms (2020: US$ 2.75 trillion). Similar to the previous years' trend, the Islamic banking and Islamic capital markets sectors were the main contributors to the increase in total value of the global IFSI, as many countries experienced a reopening of their economies and benefited from an improving global economic condition. Takaful contributions also registered a marginal improvement amid increased pressure from the effect of the COVID-19 pandemic in 2020.

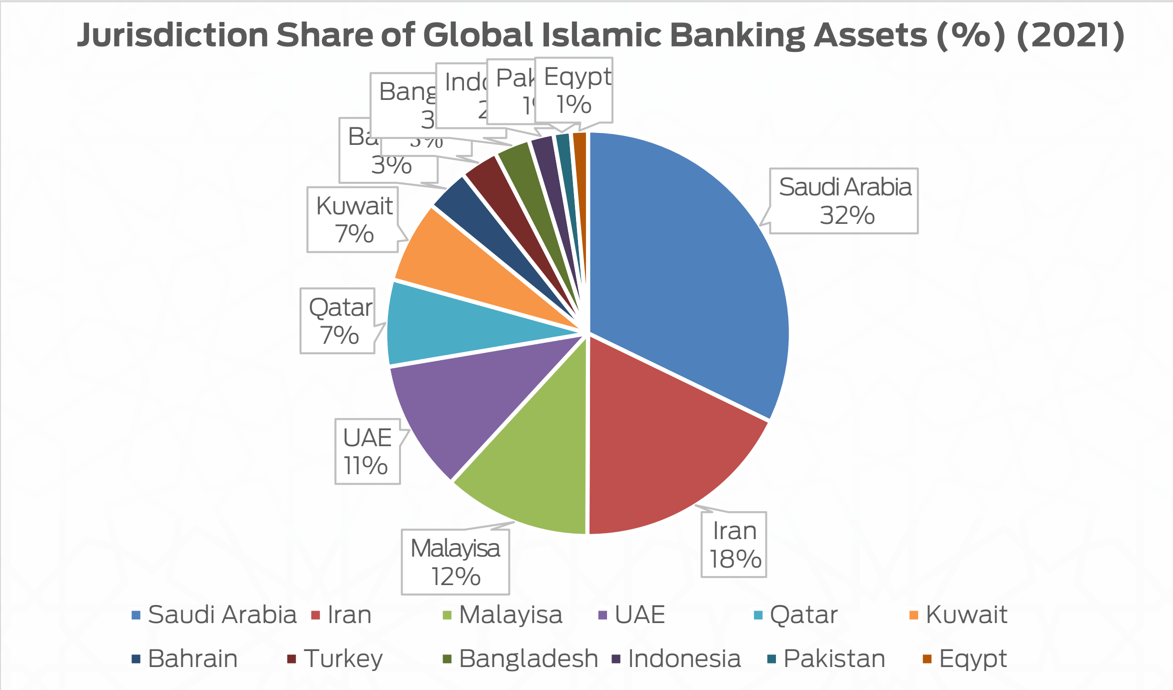
92. Breakdown of the Global IFSI by Sector and Region (US$ billion) (2021) is given below:

Region	Islamic Banking Assets	Sukuk Outstanding	Islamic Funds Assets	Takaful Contributions	Total	Share (percent)
Gulf Cooperation Council (GCC)	1,212.5	332.3	46.0	12.7	1,603.5	52.4
South-East Asia (SEA)	287.5	390.3	37.5	4.7	720.0	23.5
Middle East & South Asia (MESA)	477.1	26.9	22.0	5.6	531.6	17.4
Africa	58.2	1.8	4.0	0.6	64.6	2.1
Others	68.8	24.4	45.1	0.7	139.0	4.5
Total	2,104.1	775.7	154.6	24.3	3,058.7	100.0
Share (percent)	68.7	25.4	5.1	0.8	100	

25. https://www.statista.com

3.2.1 Islamic Banking[26]

93. Saudi Arabia accounted for 30.6 percent of the global size of Islamic banking, increasing its relative share and further strengthening its position as the key leading Islamic banking jurisdiction. While Iran's share of global Islamic banking assets dipped and accounted for 17.0 percent, improvements were recorded in the other three jurisdictions. Specifically, Malaysia accounted for 11.2 percent, the UAE for 10.0 percent, and Qatar for 6.6 percent, making up the top five jurisdictions in 2021. The other countries in the top 10 Islamic banking jurisdictions, in order of share of global Islamic banking assets, were Kuwait, Bahrain, Turkey, Bangladesh and Indonesia. Given below in the Figure 4:



94. The global Islamic banking segment, which grew by 6.5 percent and is estimated at US$ 2.10 trillion, retained the highest share (68.7 percent) of IFSI assets, and remained systemically significant in 15 jurisdictions in 2021. This number is envisaged to grow in the near term given that the proportion of Islamic banking assets relative to the entire banking system's assets increased across the many jurisdictions on the back of momentum in the reopening and recovery of economies, increased digitalization of financial services, and merger and acquisition activities. Nonetheless, Islamic banking remained largely concentrated, with the five highest jurisdictions in terms of assets accounting for 80.2 percent of global Islamic banking assets.

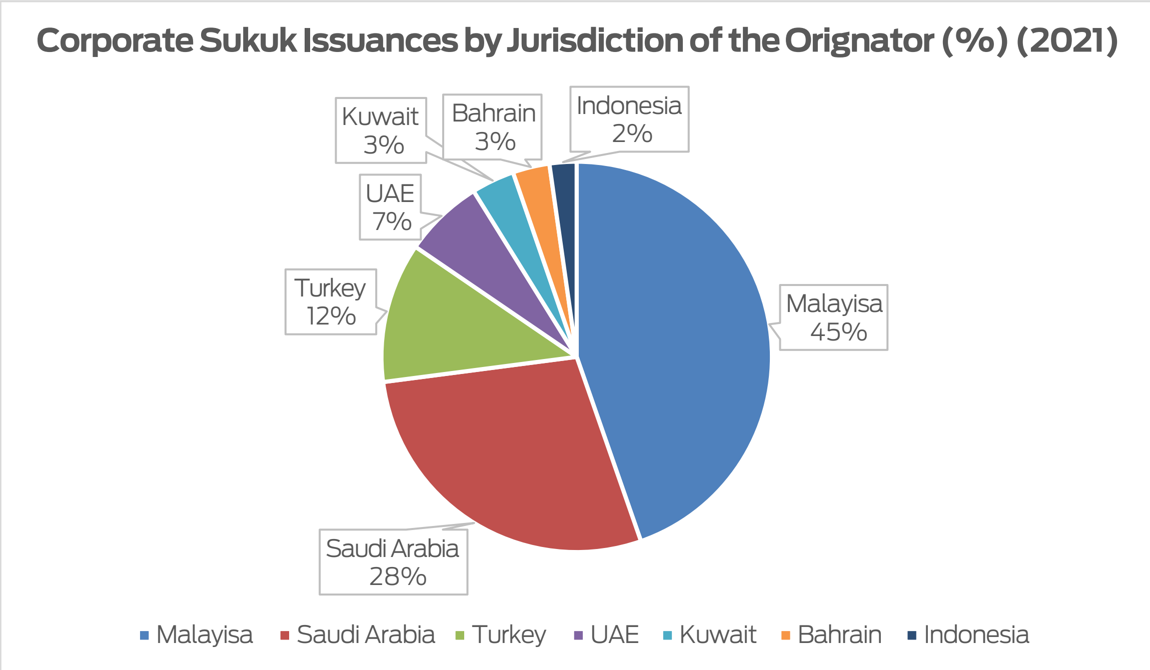
3.2.2 Islamic Capital Market

95. Sukuk outstanding reached US$ 775 billion in 2021, representing a y-o-y growth of 12.5 percent. The overall issuances by end-2021 also maintained momentum, with a y-o-y growth of 4 percent, reaching US$ 185.4 billion. While there were country-specific variations in the level of issuances in 2021, the overall global trend for the Sukuk market remained positive.

96. The largest sovereign issuers by domicile remain with Saudi Arabia continuing to be the biggest sovereign issuer in 2021, followed by Indonesia, Malaysia. Corporate issuance volume increased in 2021. Malaysia remains the largest corporate issuer in terms of overall volume of issuances, followed by Saudi Arabia and Turkey given below in Figure 5:

26. IFSB Stability Report 2022

Figure 5:[27]



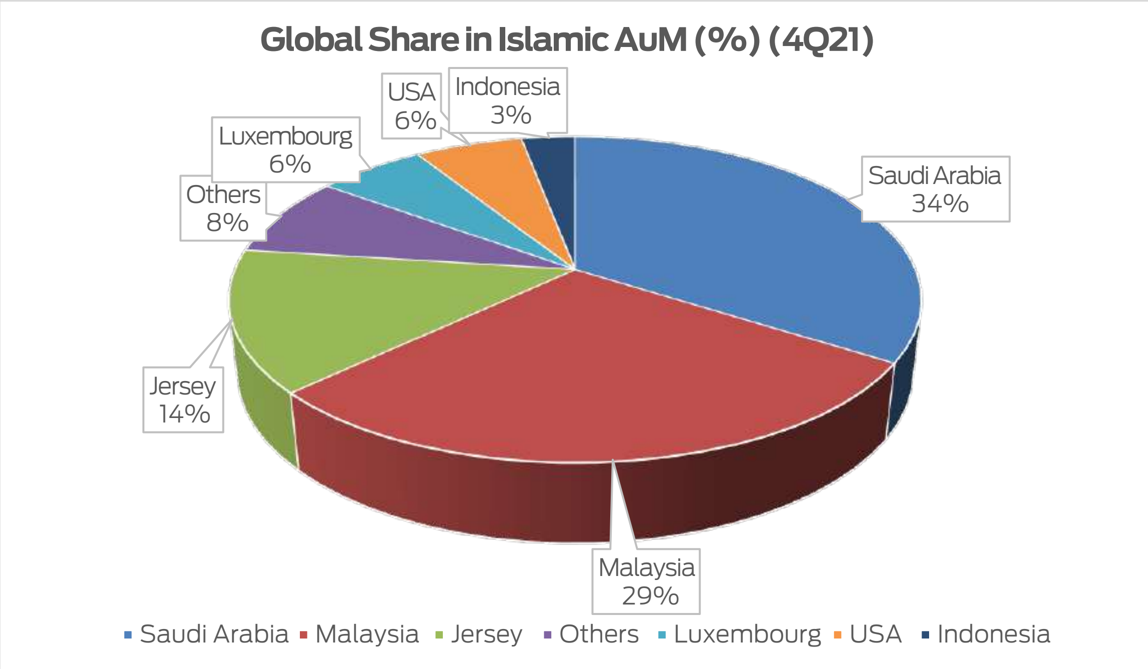
97. The Islamic capital market segment further entrenched its prominence in the IFSI for the fourth year running. Many jurisdictions returned to the market to take advantage of the reopening and recovery of their economies, favourable market conditions, and so on. The segment accounted for 30.5 percent of global IFSI assets and is estimated at US$ 930.3 billion in 2021. Supported by a resilient global risk appetite and favourable external conditions, the Sukuk sub-segment remains dominant in the Islamic capital market with an estimated value of US$ 775.7 billion and a y-o-y growth of 12.5 percent. Notably, corporate issuances improved significantly on the back of improvements in the issuance process and facilitative environments.
98. The sectoral distribution for Sukuk issuers has not changed significantly, with financial sector issuers still making up the largest proportion of Sukuk issuers after issuances by governments. In terms of origination, there were a number of new entrants to the market in 2021 and the return of issuers from jurisdictions that are not core Islamic finance markets. Sustainability-related Sukuk issuances, led by the Islamic Development Bank, Indonesia and Malaysia, have continued to grow in both existing and new markets. During 2021, sovereign entities in Saudi Arabia and Oman introduced sustainability-related debt frameworks. Following the numerous climate-focused commitments agreed to by many countries and international financial institutions during the United Nations Climate Change Convention (COP 26) held in Glasgow, Scotland, in November 2021, it is expected that sustainability-linked bonds will continue to gain prominence and help to attract funding into the emerging markets.
99. The overall Islamic capital market segment, consisting of Sukuk, Islamic funds and Islamic equities, remained the fastest-growing segment of the IFSI over the past five years. This was due to the easing of COVID-19 restrictions and the resultant improved economic conditions and growth prospects. The segment's value of US$ 930.3 billion accounted for a share of 30.5 percent of global IFSI assets. The Sukuk sub-segment also retained its dominance within the Islamic capital market segment. Despite the reduction in sovereign issuances in some oil-exporting countries due to increased revenue from the sale of oil, many new (albeit low-rated) sovereign issuances were recorded in response to the global economic recovery and increasing investor risk appetite. There were also sustainability-linked Sukuk issuances to fund development projects in some jurisdictions as they heightened their ESG activities. Sukuk outstanding registered a growth of 12.5 percent y-o-y, compared to the 7.5 percent y-o-y growth recorded in Islamic funds' assets as at end-2021.

27. IFSB Stability Report 2022

3.2.3 Islamic Funds[28]

100. Assets under management in Islamic mutual funds have increased substantially, having peaked at around US$ 130 billion at end-Q2'21 before slipping to around US$ 120 billion at end-2021. Fitch Ratings estimates that the growth rate of Islamic funds (84 percent nominal/13 percent annualised) has exceeded that of the broader global mutual fund industry (68 percent nominal/11 percent annualised), based on the latest comparable data from Lipper and ICI Global for the five years to end-Q3'21.[29] Saudi Arabia and Malaysia remain the pre-eminent Islamic fund domiciles worldwide, reflecting strongly established local markets (Figure 6). Offshore markets, such as Jersey and Luxembourg, also have nascent Islamic fund markets relative to the conventional funds market.

Figure 6:[30]



101. The total assets under management (AuM) of Islamic funds grew by 6 percent from the year 2020. There was also a 30 percent increase in sustainability-related Islamic funds from 2020, comprising US$ 6.9 billion in AuM. The global size of AuM has reached US$ 120 billion as of year ended 2021. Core domiciles for Islamic funds remain unchanged, although the overall share of core markets has contracted slightly, signaling the growing size of other markets. In the Islamic equity markets, a key trend in 2021 was a sector rotation from growth stocks, such as the technology sector (which did well at the outbreak of the pandemic), to defensive and cyclical stocks. Overall, Islamic indices experienced similar movements to the conventional market, but again outperformed their conventional counterparts in 2021.

3.2.4 Takaful[31]

102. Takaful remains the smallest segment of the global Islamic finance industry, with its share of the total worth of the global IFSI reaching 0.8 percent in 2020 based on IFSB data. In a number of markets, Takaful contributions and its domestic market share have been growing over the last few years.

103. In Saudi Arabia, insurance is provided by insurance companies operating in accordance with the principles of cooperative insurance, which states that the provisions of the articles of incorporation should not be inconsistent with the provisions of the Islamic Shariah. But in the UAE, Malaysia and Pakistan, Takaful is the dominant form of Islamic insurance. Takaful growth is mostly driven by regulatory push – for example, health

28. https://www.fitchratings.com/
29. http://www.lipperleaders.com/
30. IFSB Stability Report 2022
31. https://www.fitchratings.com/site/Islamicfinance

health and motor insurance in Saudi Arabia and the UAE.

104. Malaysia is the third-largest Takaful market globally, according to the IFSB, with a vibrant Islamic finance ecosystem that includes Islamic banks, Shariah-compliant corporates, Islamic fund managers and halal industries that seek Takaful products. Indonesia's Takaful sector continues to expand, with market share at 9.0 percent of the country's overall insurance market in November 2021 (November 2020: 7 percent). The large rise in Islamic insurance market share was caused by a 41 percent y-o-y increase in life Shariah products. In contrast, conventional life insurance expanded by only 3 percent.

105. Despite structural developments in the Takaful segment, especially via digitalisation, its share of the IFSI's asset worth remains marginal. The overall Takaful sector's direct contributions increased by 4.8 percent y-o-y to US$ 24.2 billion in 2020, after a significant decline (–14.8 percent) in 2019. The sustained growth recorded in the segment is the positive outcome of supervisory relief measures and forbearances taken in the wake of the pandemic outbreak and subsequently. The regulatory framework for the Takaful sector has improved in the majority of countries in recent years. Different measures are being introduced. In particular, the introduction of risk-based capital regimes in some jurisdictions has prompted a greater emphasis on technical profitability, as volatile equity and property investments could require higher solvency capital charges.

106. The Takaful segment's market share of the global IFSI remains marginal at 0.8 percent. Nonetheless, the segment registered a growth of 5.2 percent y-o-y to reach US$ 24.3 billion as at end-2020. The growth was achieved due to improved economic conditions as economies reopened following relaxation of the various lockdown measures, especially in the last quarter of 2020. Other contributing factors include increased digital transformation activities through which Takaful operators leveraged on technology to capture the growth potential in health and family Takaful business lines. Additional factors include (but are not limited to) increased public awareness and appreciation for Takaful offerings, and the positive impact of the various COVID-19 policy support measures taken by the various governments.

CHAPTER 4:
KEY ISSUES AND CHALLENGE IN NON-BANK ISLAMIC FINANCIAL SECTOR OF PAKISTAN

107. In order to identify and document key issues and challenges in non-bank financial sector, the published reports and documents, in-house reviews and feedback received by the IFD of SECP through a series of meetings and interactions with key industry players, have been reviewed. Accordingly, this chapter and the following, have been drafted and presented for review of the members of the Committee constituted by the SECP for the promotion of Islamic finance in the non-bank financial sector. The said committee has been primarily mandated to conduct a gap analysis to identify potential bottlenecks and opportunities for development of Islamic finance in capital market, other non-bank financial sectors and insurance industry. On the recommendation of the committee, the feedback from the industry was also solicited through letters and feedback received also be incorporated. The input from the stakeholders and market players is enumerated below as issues and challenges.

4.1 Industry Level Issues

108. The industry wide macro issues, equally impacting the overall financial system and capital markets, also have material impact on the non-bank Islamic financial sector of Pakistan. These issues can broadly be summarized, as follows:

4.1.1 Undocumented economy

109. A substantial portion of economy is undocumented and participants of economic activities generally resort to and dependent on informal channels for meeting financial needs.

4.1.2 Low savings rate

110. As per the data of the World Bank[32], gross domestic savings (percent of GDP) of Pakistan was 4.5 percent in 2021, which is lowest in the region (India, Bangladesh and Sri Lanka, all have saving rates above 20 percent). The data also indicate a consistent declining trend in saving rate since 2004 when it was reported as 17.4 percent. As a result, a very small portion of public savings reaches the real economy through the financial system.

4.1.3 Fewer listed companies and that too with smaller free-floats

111. At one end, companies, particularly SMEs, are starving for financing, but on the other hand, only a few are approaching the capital markets to raise funds. With exception of few, the existing listed companies has limited free float thereby limiting the capacity for trading in the secondary market.

4.1.4 Small number of active investors

112. There are very small number of investors in Pakistani capital market i.e. 220,000 as compared to the investor base linked with the CDNS i.e. around 3 million. Whereas, the number of bank accounts in Pakistan is 66.13 million as of March 2022, according to data by the SBP. The low investor base is leading to other problems like low volumes, difficulty in fund raising inefficient price discovery and consequently impaired investor confidence. Similarly, institutional investor base in form of mutual funds, pension funds, insurance companies, retirement schemes, etc. is also limited.

4.1.5 Lack of viable investment alternatives

113. Due to the fewer formalized and lucrative investment options, a large chunk of public opts the informal investment schemes, including the traditional “committee system”.

32. https://data.worldbank.org/indicator/NY.GDS.TOTL.ZS?locations=PK

4.1.6 Limited outreach

114. The financial service providers in general and capital market intermediaries, in particular, have presence only in major cities. The digital or online services offered by these service providers are still at infancy stage.

4.1.7 Lower public confidence

115. Due to past economic crises and financial scams, the capital market and non-banking finance sector have lost the confidence of investors. Both the providers and users of funds sometimes feel reluctant to engage in capital and private debt market.

4.1.8 Lack of awareness and trained human resources

116. The general public is largely unaware of the products and services provided by non-bank financial institutions, and even those who deal with banking institutions are largely unaware of non-bank financial services.
117. People are generally ignorant of the other options available for the Shariah-compliant investments, so they prefer to place their deposits with an Islamic bank. Most people are not familiar with the Islamic mutual funds, Modaraba certificates and other available Shariah-compliant investment alternatives.
118. The lack of trained human resources in the area of Islamic banking and finance is also a potential challenge, which has resulted in a lack of conviction for Islamic finance and informed decision-making among the staff of Islamic financial institution.

4.2 Islamic Finance Industry Specific Issues and Challenges

119. The key issues, challenges, and recommendations have been very well documented in the Capital Markets Development Plan and Road Map 2020–2027, approved by the Government of Pakistan, on the recommendation of ADB. To avoid unnecessary repetition, the same has not been covered here, and references to the aforementioned document can be made as needed.
120. The identified key impediments hampering the growth and development of non-bank Islamic finance are listed below under the respective pillar, -

4.2.1 Absence of enabling legal and regulatory framework

4.2.1.1 Absence of clear legal framework for Islamic finance industry

121. Legal and regulatory frameworks play a pivotal role in the development of any regulated sector and Islamic finance industry is no exception to that. Comprehensive financial laws bring required clarity for every stakeholder, enable development of medium-to-long term strategies, support business growth, expansion and help to complete financial ecosystem.
122. Primary laws are the main source for developing robust legal, regulatory, and operational frameworks, with the support of subsidiary legislation. Pakistan's non-bank financial sector has seen a legal and regulatory overhaul in the recent past. Unfortunately, the said overhaul primarily covers the conventional market with limited provisions for the development of Shariah-compliant institutions, products, and processes within the non-bank financial sector. In fact, the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980, is the only primary legislation dedicated to Islamic finance in the non-bank financial sector and is already four decades old.
123. The number of Islamic financial institutions, size of Islamic financial assets, and footprint of Islamic financial services within the non-bank financial sector have witnessed tremendous growth in the last decade. The higher proportion of Shariah-compliant securities' market capitalization on the stock exchange and the majority of total Islamic assets in voluntary pension funds demonstrate the importance of Islamic finance in the non-bank financial sector. The growth of the Islamic mutual fund industry, Takaful operations, non-bank micro Islamic finance companies, etc., are also evidencing the need for better regulations and the development of Islamic financial services within the non-bank financial sector. In order to promote the growth in these sectors, there is a need for the legal framework for the Islamic private funds, REITs and non-bank micro finance companies.

124. The REITs Regulations, 2015 provide little guidance for flotation of Shariah-compliant REIT schemes, the regulations governing private funds do not clearly provide for Shariah-compliant private funds. These regulations should be amended to categorically recognize Shariah-compliant scheme, as a distinct option.

125. Except for Takaful industry, no regulatory framework provides mechanism for conversion into Islamic financial institution and offering Islamic windows solutions. In order to encourage and support, conversion of regulated persons and opt for Islamic windows, a simple yet efficient enabling regulatory framework should be provided.

4.2.1.2 Unresolved issues pertaining to quantitative tolerance levels in stock screening process under the Shariah Governance Regulations, 2018

126. The Shariah Governance Regulations, 2018 were notified in 2018 but some key issues are still unresolved. The Shariah stock screening of listed securities i.e. variation between Shariah stock screening criteria (quantitative tolerance levels) of AAOIFI and KMI All Shares Index, absence of a mechanism to improve transparency in the stock screening process and non-applicability of the regulations to Islamic collective investment vehicles (AMCs, mutual funds) are the key areas requiring regulatory intervention for resolving long-outstanding issues. The delay in the effective implementation of the regulations is posing a possible perception of weaken enforcement by the regulator.

4.2.1.3 Limitations and restrictions imposed under the Shariah Advisors Regulations, 2017

127. The regulations are very restrictive in nature, as they prohibit registered Shariah advisors, particularly those in corporate structures, from engaging in advisory services beyond four assignments. Other services provided by financial market intermediaries are not restricted in any way. The framework also does not recognize Shariah boards established by Islamic banks under the SBP's Shariah Governance Framework. There are also concerns about Shariah advisors' scope of work, as regulations appear to limit them to Shariah-compliant companies and securities and do not allow for advisory services in other regulated avenues such as Modarabas, Takaful, Islamic lending services, Islamic mutual funds, Islamic pension funds, and so on. The regulations therefore require revamping to address these issues.

4.2.1.4 Outdated Modaraba laws

128. The Modaraba Companies and Modaraba (Flotation and Control) Ordinance, 1980, and Modaraba Companies and Modaraba Rules, 1981 are four-decade-old laws that have never been holistically updated as per the modern-day needs of financial markets. The SECP has moved several key amendments to the Ordinance through the Modaraba Ordinance (Amendments) Bill, but the same is still in the legislation approval process after three or more years. The proposed amendments can strengthen the Modaraba sector in Pakistan and attract new market players for inclusion in formal Islamic financial structures. These amendments include the concept of unlisted/private Modaraba which will be beneficial for those who are interested to begin as private Modaraba for first few years to establish their venture and then go for public offering after showing satisfactory performance to the potential investors; therefore, an early promulgation of the Amendments Bill shall be targeted. The same amendments are also required to be made in the Modaraba Rules.

4.2.1.5 Pending amendments to the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003

129. The SECP has proposed several amendments to the NBFC Rules, which have been placed for final approval by the Federal Government. These proposed amendments will bring ease of doing business for financial intermediaries operating within the domain of these rules, by enabling multiple licenses in a group and provision for regulatory sandbox.

4.2.1.6 Application of dual regulations on Islamic financial industry

130. Every Shariah-compliant non-bank financial institution, Shariah-compliant company, and Shariah-compliant securities issuer in Pakistan is subject to dual regulations (both Islamic and conventional). The additional layer of Shariah governance raises costs and introduces inefficiencies, impeding and discouraging the growth of the non-bank Islamic financial market. Efforts are required to reduce the regulatory burden and apply the concept of proportionality.

4.2.2 Limited availability of suitable products and innovation

4.2.2.1 Non-existent retail Sukuk market

131. The prevalent market for Sukuk is very shallow and due to limited supply, there is constantly high demand. Mostly, the big players in financial industry, acquire and hold good quality Sukuk, particularly sovereign and quasi sovereign Sukuk. As a result, there are practically no options for small and retail investors to access Sukuk market. For the financial inclusion and easing the access to the finance, the participation of the retail investors in the whole process is of sheer importance. It is therefore important to introduce innovative ways, such as Sukuk tokenization, Sukuk fractionalization or Sukuk based ETFs to enable retail investors to participate in the segment.

4.2.2.2 Struggling business models of Modarabas

132. The Modaraba sector, in particular, has the ability to play an important role in serving microfinance needs and collaborating with other ventures as partners. After the tax exemption was removed, the sector expected to reintegrate its business plan and look for new business opportunities. It's critical that the industry keeps up with the changes and expands its reach through technologically advanced products and services. The total size of the Modaraba sector is Rs. 61.46 billion, which comprises only 2.8 percent of the whole NBFI industry as on June 30, 2022.
133. In Pakistan, there are an estimated 5.2 million small and medium enterprises (SMEs). Their contribution to the GDP is estimated to be 40 percent, while that of exports is estimated at 25 percent. The potential market for SME financing in Pakistan ranges between Rs. 3-4 trillion, of which formal finance meets only 15 percent to 20 percent, while the rest is either financed through informal channels or remains unmet. NBFCs and Modaraba's lending to SMEs was 46 percent in FY18 and 40 percent in FY19. This shows that SMEs rely significantly on financing from NBFCs and Modarabas, and NBFCs are essential in filling the gap that exists. Furthermore, only 23 percent of the population has a bank account; the rest of the population still uses antiquated methods of storing money and saving and investing. Most of the banked population is familiar with and relies only on the banking sector in Pakistan, which leaves a very low margin for the non-banking finance companies to tap those investors.
134. While many key players are leaving the Modaraba sector, the Modaraba sector still offers a wider range of financial services that can be offered through Modarabas. This requires that this sector keep up with the times and broaden its reach through technologically innovative products and services. The interest of a new player to float Modaraba in the field of renewable energy is evidence of the great potential the sector possesses, provided that the Modaraba sector can introduce new products and services by focusing on new markets and technologies.

4.2.2.3 Lack of innovation in Modaraba sector

135. Modaraba sector has been relying on the archaic models of business with very limited focus on the fintech and modern distribution channels, making it uncompetitive with other industry players.

4.2.2.4 Absence of alternate funding channels

136. In the absence of appropriate frameworks, alternative platforms such as Islamic crowdfunding are

nonexistent. The development of enabling regulatory frameworks and platforms, including Islamic equity crowdfunding and Islamic P2P financing, could play a meaningful role in supporting the development of an inclusive financial system.

4.2.2.5 Limited distribution channels

137. The age-old method, the agent-led model, where a person sells financial products through in-person meetings, is slow, expensive, prone to mis-selling, and doesn't scale well. The other traditional channel is sales through other institutions like Banca Takaful, but again, such a model is prone to miss-selling and is also expensive (commission sharing with the bank and its employees). The third and more recently developed channel has been telecommunications companies, which have allowed financial institutions to reach customers at the bottom of the pyramid with microproducts. A customer is pitched a product over a call and gives consent via USSD code and amount deducted from their phone. While this model has had success in Pakistan, it has its limitations since it is a pushed product and not cashless, and customers do not receive anything physically. Additionally, telecoms charge huge commissions of up to 30 percent, having reached revenue saturation with their main lines of business, increasing the price of the product for the end customer.
138. The Islamic financial service providers in the non-bank financial market are facing a serious business challenge in the shape of limited distribution channels as they have footprints in three major cities only. Being at the nascent stage, they have yet to exploit the true potential of technology. Expansion of distribution channels through fintech adoption and any support mechanism to enable Islamic financial service providers to adopt tech-based solutions for distribution channel expansion will be extremely beneficial.

4.2.2.6 Underdeveloped Takaful industry

139. The Takaful market in Pakistan is still in a formative stage, and market projections estimate growth rates of 10 percent over the next 10 years, reaching Rs. 120 billion in premium by 2025. The potential challenges in customer services and productivity, technology can enable this growing industry through its formative stage.
140. Pakistan saw its first Takaful operator, in the General side, start in 2006. The asset size of Family Takaful sector is Rs. 76.521 billion and General Takaful is Rs. 12.21 billion as of June 30, 2022. Number of market players is 35 including 6 dedicated Takaful operators and 29 window Takaful operators.
141. Pakistan is among the top 10 most populous nations in the world. This makes it a very fertile market for Takaful, one with some interesting challenges. Takaful is the latest "wave" in financial protection. Increasing personal debt, the widening divide between the haves and have-nots, and other such issues regularly plague those in rapidly growing developing nations. Pakistan is one of those countries.
142. To truly comprehend the opportunities for Takaful in Pakistan, there is need to see where the present insurance sector stands and. The best way to understand this by comparing it to another nation which shares many traits with Pakistan. Gross premiums are 0.92 percent of Pakistan's GDP.[33] This is significantly lower in comparable countries like India where the percentage is 4.12[34] and in Vietnam this stands at 2.24 percent, while globally it stands at 7.2 percent of GDP. These values make it very clear that there exists a significant gap in Pakistan for financial protection tools.
143. Unlike the insurance companies, the Takaful operators' primary source of revenue is the Wakalah fee. This gives them relatively little room to maneuver, so they will need to work very hard to ensure that their operations are not just effective but also lean. Thus, the challenges are not small by any measure, but they can definitely be overcome. If the present and future Takaful operators are not just looking at going after those individuals who are "religion-centric," they need to look at positioning their offerings in a slightly different manner. The key selling proposition would have to be that Takaful products should be based on the following variables: need-based, appropriate pricing, and immaculate customer service. An additional feature would be that the products are Shariah-compliant, and so customers need not compromise on their beliefs to be able to get the best in financial protection.
144. Therefore, there is need to adopt a focused approach and develop a robust action plan to enhance

33. https://macropakistani.com/insurance-in-pakistan/
34. https://www.moneycontrol.com/news/business/indias-insurance-penetration-sees-marginal-improvement-in-fy21-shows-swiss-re-data-7172391.html

penetration in Pakistan, particularly targeting state insurers to concentrate and promote Takaful operations.

4.2.3 Structural and approach issues

4.2.3.1 Incomplete Islamic finance ecosystem

145. In any financial system, different components, including financial institutions and financial markets, support and supplement each other. For example, the funding needs of a business change with time and maturity. Initially, seed capital from sponsors and capital injection from angel investors may be required. However, at the next stage, it may be required to borrow from a lending institution and/or seek private equity from venture capitalists. Subsequently, such venture capitalists need to take an exit, preferably by realising the true value of their investments by listing them on the stock exchange. The stock market can then be used by a company by offering equity, debt, or hybrid securities and choosing to list on the stock exchange. In this example, we have tried to explain linkages and interdependences across different segments, platforms, and intermediaries.
146. Similarly, the limitations of Islamic banking and characteristics of non-bank Islamic financial institutions, require the parallel development of Islamic finance. However, in Pakistan, Islamic banks have achieved considerable progress, whereas non-bank Islamic financial institutions and the Islamic capital market are still at a nascent stage with non-existent private equity, credit rating and enhancement institutions.
147. It is therefore important to holistically review Islamic finance landscape in Pakistan and address the weak areas on priority.

4.2.3.2 Absence of coherent strategy for promotion of Islamic finance in non-bank financial sector

148. The policy work relating to non-bank financial sector is presently divided into four independent departments at the SECP. There are two departments in the Securities market division. Primary market approvals and development department, as its name indicate, is mandated with policy development for primary capital market and related matter where Policy, regulation and development department focuses on the issues concerning securities market (secondary capital market). The policy, regulation and development department of specialized companies division is responsible for asset management companies, non-banking finance companies, pension funds and related matter and the policy, regulation and development department of insurance division deals with similar matters of insurance industry.
149. It is evident from the above that the policy framework for the non-bank financial sector has been developed on a sectoral basis. However, since each of the sectors is dominated by conventional counterparts, the focus of all the departmental activities is primarily on the conventional side, and the focus on the Islamic side of these sectors gets marginalized.
150. It is therefore imperative to bring the entire policy work at SECP into umbrella of Islamic finance through promulgating master (umbrella) regulations applicable to the SECP all regulated sectors. All the sectoral regulations, shall make a reference to that master regulations, for the matters pertaining to Islamic finance. Further, policy and regulatory framework for each of the financial service, product and ancillary matter shall provide for enabling provision for Shariah-compliant alternatives.

4.2.3.3 Limited liquidity management options for Islamic financial institutions and absence of lender of last resort for the non-bank financial sector

151. Islamic banks and other Islamic financial institutions are facing immense challenges in managing their liquidity in an efficient way. Undeveloped Islamic money markets and a limited supply of instruments by the central bank are making it difficult for Islamic financial institutions to manage liquidity. The PMEX previously introduced a regulated commodity Murabaha platform for this purpose, but it could not sustain itself due to its reliance on a single player. Further, no lender of last resort exists in the non-bank financial sector and stipulated mechanism for the liquidity management. It is therefore important to reactivate such a platform with multiple options and a basket of commodities to enable Islamic financial institutions to manage liquidity from day to day in a transparent manner and devise a mechanism for the liquidity management including the provision for the lender of last resort for the non-bank financial sector.

4.2.3.4 Limited capacity of non-bank Islamic financial institutions to mobile resources

152. The capacity of non-bank financial institutions in general and Islamic institutions in particular is severely constrained due to the non-availability of affordable avenues for resource mobilization. Most non-bank financial institutions are dependent on capital injections, as only a few of these institutions are allowed to mobilize financial resources through certificates of deposit (certificates of Musharaka), which is akin to deposit taking. The fund mobilization constraints through Islamic banks mainly relate to higher costs, a volatile interest rate scenario, the squeezing of margins, the non-availability of long-term funds, the non-availability of multilateral credit lines, etc. There is a need to enable non-bank Islamic financial institutions to mobilize financial resources through the capital market by way of Sukuk issuances including Tier-I and Tier-II Sukuk. Any support mechanism, framework for Tier-I and Tier-II capital will immensely enhance the capacity of non-bank Islamic financial institutions to mobilize financial resources through Sukuk issuances.

4.2.3.5 Non-conducive taxation regime for non-bank Islamic finance and weak understanding of taxation authorities on Shariah compliant modes of finance

153. As mentioned earlier, Islamic finance in non-bank financial sector is still at nascent stage and a strong candidate for fiscal incentives in form of tax rebate and tax credits. The 2 percent tax rebate was allowed in 2016 to the Shariah-compliant manufacturing companies and was withdrawn, at once, through the Finance Act, 2021. Further, the tax exemptions for modaraba in lieu of the income earned by the Modarabas, other than the trading modarabas, is fully exempted from income tax provided they distribute 90 percent of their profits amongst the certificate holders, was also withdrawn through the Finance Act, 2021. As prevalent in many other jurisdictions, tax incentives for Shariah-compliant companies, securities, intermediaries and investors are required for the development of Islamic capital market in the Pakistan.
154. Further, due to the inadequate knowledge and weak understanding of taxation authorities on Shariah compliant mode of finance and investment, the tax authorities at federal and provincial levels some time create tax demand which are not rationale or based on factual position and often creates difficulties for operating entities and shake the confidence of investors and sponsors.

4.2.4 Capacity, perception and awareness issues

4.2.4.1 Non-visibility of Islamic components of non-bank financial markets

155. A large number of listed companies are Shariah-compliant and market capitalization of such companies is more than 60 percent of total market capitalization at PSX. Review of the trading activity at PSX during last financial year also transpires that majority of trading activity was carried out with this Shariah-compliant segment. Similarly, 35 percent assets under management of mutual funds schemes, and 65 percent assets under management of private pension fund schemes are Shariah-compliant. However, there is little visibility of these segments, as components of Islamic capital market.
156. For the same reason, it is important to not only recognise the presence of the Islamic capital market but also project it effectively to all stakeholders. This will, certainly, inflate the demand from Shariah-conscious investors and other stakeholders, ultimately leading to the growth and development of the Islamic capital market.

4.2.4.2 Lack of trained human resources

157. One of the key constraints has been identified as lack trained human resources. This is true at both the regulator and intermediary levels. Trained human resources can play an instrumental role in the formulation of key policies, eradicating misconceptions, improving acceptability of Shariah-compliant products and services, and propagating Islamic financial services among the masses. A collaborative effort with industry and academia is essential to achieving the desired outcomes.

4.2.4.3 Discouraging past practices eroding public confidence

158. Scams and mis-selling are thought to be two major issues eroding public trust in Islamic financial services. The fraud committed in the name of Modaraba, as well as numerous reported instances of mis-selling Takaful products, shattered public trust. With a proactive approach and effective enforcement, this menace can be controlled. A coordinated effort for remedial measures from all stakeholders, including regulators and law enforcement agencies, is very important to address this issue.

CHAPTER 5:
POLICY RECOMMENDATIONS AND ACTION PLAN

159. The findings suggest that to strengthen the Islamic financial system in a country that supports the real economy and fosters the private sector as the main engine of national growth, the role of Islamic finance in the non-bank financial sector will be increasingly important in mobilising private capital. When building the foundation for an advanced Islamic financial system, it will be required to broaden the avenues for capital formation and investment and deepen the financial market to support the development of the real economy. In light of the foregoing, and considering the SECP's regulatory mandate in light of FSC judgments, as well as suggestions received from stakeholders, the following policy recommendations for appropriate actions have been made:

5.1. Accelerate the growth of Islamic finance in regulated sectors

160. For this purpose, introduction of new Islamic financial products and continuously improving existing Islamic financial products is necessary including the Shariah compliant investment products offered by the CDNS In order to provide appropriate solutions to satisfy financial needs of providers of funds (investors, liquidity providers, financiers, etc.), users of funds (companies, entrepreneurs, government, customers, etc.) and intermediaries connecting the two, availability of suitable financial products that are not only Shariah-compliant but also capable of serving the desired needs in efficient and effective manner, is inevitable. With the advent of technology, new ways and means have to be explored for offering innovative products. In this regard, following specific products have been included in this recommendation; -

5.1.1 Implement the proposal of stock trading at T+0 basis

161. To attract Shariah conscious individual and institutional investors and to reduce their price risk in the regular market operating on T+2 cycle, implement the proposal of stock trading at T+0 basis. The proposal has already been approved by the SECP and its earlier Shariah Board (replaced with SAC), however, its implementation is pending for quite some time.

5.1.2 Re-activate commodity Murabaha facility at PMEX

162. This facility is currently dormant. One of the participants in the facility was Hascol Petroleum, which provided the underlying commodity for the Murabaha contract. However, Hascol Petroleum ceased being a participant in the facility, following which the facility has remained inactive. There is a need to reactivate this platform with the inclusion of multiple commodities and by leveraging the framework for electronic warehouse receipts. Activation of this platform is vital for liquidity management by the Islamic financial institutions and may also become a useful conduit for the SBP and MoF for the liquidity management in a Shariah compliant manner.

5.1.3 Ensure availability of retail Sukuk

163. Attracting Shariah-compliant investors to the capital market and creating a competitive market for better returns for investors are critical. This may be ensured through more sovereign Sukuk listings, like those of power-holding Sukuk. For this, the debt policy of the government shall specifically provide for listing plans for Sukuk. The use of blockchain and other technologies for the issuance of small denominated Sukuk or fractions of Sukuk can open up new avenues of Shariah-compliant investments for retail customers. To begin, existing Sukuk portfolios of Islamic financial institutions will be extended to retail investors through Sukuk tokenization or fractionalization.

5.1.4 GoP Ijarah Sukuk rules be amended to allow Asset Light Sukuk structures

164. To expand GoP Sukuk universe, allow Asset Light Sukuk structures by amending GoP Ijarah Sukuk rules or frame another set of rules in light of ALS Framework. This will not only create flexibilities for the government by reducing dependencies on assets for Sukuk issuance but also introduce sovereign Sukuk with varied features suitable for separate classes of investors. Further, presently, NCCPL and CDC have been allowed to work as a "special primary dealer" (SPD) for T-bills and PIBs; however, to promote Sukuk investment amongst the retail investors of the stock market, the status of SPD may be further extended to cover GoP Ijarah Sukuk.

5.1.5 Develop Shariah-compliant digital lending products and platforms

165. Considering a surge in digital lending activities under the NBFC regime, the market for micro and Nano loans is expanding at a rapid pace, and so far, more than 2.5 million loans have been disbursed to individual borrowers, amounting to Rs. 33 billion by the licensed digital lenders as of June 30, 2022. However, there is no regulatory framework available for Shariah-compliant digital lending products and platforms. Hence, a clear enabling regulatory framework and a strategy to promote Shariah-compliant digital lending products and platforms should be adopted.

5.1.6 Allow Islamic social finance through the institution of Waqf

166. To cater Shariah-compliant asset-management needs of Waqf institution, allow Islamic social finance linkage with CIVs models and Sukuk.

5.1.7 Allow Islamic crowdfunding for resource mobilization

167. Crowdfunding has a mammoth potential for Shariah-compliant Islamic equity or debt-based resource mobilisation by Islamic financial institutions and is gaining momentum worldwide. However, crowdfunds are restricted in Pakistan due to some restrictions in the Securities Act, 2015. There is a need to explore options, particularly through the making of rules by the federal government to allow Islamic crowdfunding while addressing the restrictions of the laws. Alternately, proposed amendments to the Securities Act of 2015 that would allow crowdfunding to be pursued effectively could be promulgated early.

5.1.8 Support the development of new collective investment schemes for small savers

168. Under the existing schemes, the target investors do not include students, kids account, housewives, low-income persons, the salaried class, or agriculturalists. There is a need to develop new collective investment schemes for this class of small investors including the traditional “committee system investors” wherein small investments can be pooled and invested in a Shariah-compliant way at minimal cost. Similarly, gold-linked savings and investment microproducts can be offered by Islamic asset management companies to fulfil the needs of small savers with an enabling environment where market making of physical gold is made possible at regulated platform.

5.1.9 Revisit banca Takaful product by revising the product model

169. Consider revisiting the banca Takaful product structure in light of Meezan Bank Limited's structure and lowering the bank's upfront, exorbitant commission. This commission amount may not be deducted upfront all at once and may be capped at a reasonable level. Similarly, all Takaful operators shall be directed to ensure that products offered by them do not allocate less than 60 percent to the fund. This will address many policyholders' concerns while also assisting the industry's long-term development.

5.1.10 Enable increased flotation of modarabas

170. The Modarabas are a unique institutional structure for Islamic finance that is flexible enough to venture into all sorts of Shariah-compliant businesses, including pure financial services, leasing, real-estate development and management, project-based financing, etc. Hence, there is a need to initiate a drive by bringing success stories into limelight and encourage industry to opt for unique product models.

5.1.11 Encourage listed companies to get declaration as Shariah-compliant companies

171. While there are more than 250 companies classified as Shariah-compliant companies in the KMI All Shares Index, only handful of them have approached SECP to get certification of Shariah-compliant. The declaration of a Shariah-compliant company under Section 451 of the Companies Act, 2017 can assist the listed companies to pursue the course to comply with constitutional requirement and attract and retain Shariah conscious investors, employees, suppliers, clients, etc. Further, under the Fourth Schedule of the Companies Act, 2017, every listed company, which is conducting its business according to the principles of Shariah, and the companies listed on Islamic index, is obliged to disclose some additional information through the financial statements including bifurcation of income, loan and investment into Shariah-compliant and non-Shariah-compliant. However, till date a limited number of companies are disclosing the said information. It is therefore imperative that not only the Shariah disclosure requirements be enforced effectively, but the listed companies also conducting Halal businesses should be pursued to apply for grant of certification under the Act for the sake of promoting development of Islamic finance in line with constitutional requirement to eradicate Riba from the economy. Further, the efforts should be undertaken to secure an incentive for the Shariah compliant companies in form of tax rebate.

5.1.12 Promote the Issuance of Shariah-compliant securities should be facilitated and promoted

172. It can be achieved through standardization of Shariah structures, simplification of documentation and making the approval process more efficient. It is particularly important in the case of short-term securities that are to be issued by companies to meet working capital requirements. In case of series of issues, on similar Shariah structure, the requirement to seek and obtain approvals for each issue shall be waived through regulatory intervention. In order to further facilitate listing of Shariah-compliant securities, the provisions of Shariah Governance Regulations, 2018 and the Public Offering Regulations, 2017 should be synchronized.

5.1.13 Promoting effective collaboration with stakeholders

173. It is vital for the development of Islamic finance within the regulatory ambit of the SECP. For this reason, it is of paramount importance to activate the CEIF alliance, an alliance of SECP and three centers of excellence in Islamic finance. Engaging students and academics in entrepreneurial competitions in incubation centers, combined with background empirical research, can aid in the development of new Islamic financial products. Additionally, capacity building of the industry and regulators through specific training and a series of awareness events will promote Islamic finance through innovation.

5.2 Achieve greater standardization in the Islamic financial industry

174. The reputation and credibility of Islamic financial institutions rely on their ability to adhere to Shariah injunctions. Globalization and internationalization in Islamic finance have accentuated the need to create standardization and harmonization in Shariah practices, their accounting treatments, and governance in an integrated framework across the globe. Consistency in Shariah practices and their accounting treatments is instrumental in strengthening the trust of the general public and paving the way for positive public perception. At the moment, the focus of standardization is limited to the adoption of Shariah standards on a need-to-know basis. Over the period of experimentation and regulatory interventions around the globe, it has been found that the existing strategy for adoption deployed to bring standardization to Islamic financial institutions is less effective and marginally efficient. The existing strategy lacks comprehensiveness as it largely relies on the adoption of Shariah standards only. It further ignores the integration between Shariah, governance, and accounting standards, which is necessary for the credible functioning of Islamic financial institutions. Lastly, the existing strategy offers a very passive and less interactive process of adoption regarding industry feedback and

doesn't effectively contribute to the industry's readiness for standardization to its true potential. A paradigm shift in the existing strategy for adoption of global standards, is therefore, inevitable. A holistic approach for adoption consisting of a full range of relevant Shariah, accounting, and governance standards deployed in line with global best practices is desired. The adoption will be attempted in an integrated framework to ensure the smooth operation of Islamic financial institutions with increased confidence and credibility. Considering the maturity level of the Islamic finance industry within regulatory domain of SECP and to address practical difficulties in implementation of standards, a staggered approach, is required to be developed and implemented.

5.3 Improve the quality of Islamic financial institutions' operations

175. Islamic financial institutions within the regulatory ambit of SECP are not mature enough when compared to the Islamic banking institutions in the country. The Modarabas, Mutual Funds and Takaful sectors are relatively mature; however, other institutions interested in offering Islamic financial services under the NBFC and capital market regimes must proceed gradually. This is critical for the development of these institutions in accordance with their overall goals, such as improving the quality of their operations and expanding the services they provide. The goal here is to develop an enabling regulatory environment for sustainable, practical, and self-regulated operations of Islamic financial institutions within the regulatory ambit of SECP. In order to achieve this, following are some specific recommendations, -

5.3.1 Provide guidance and assistance to regulated persons and others who provide Islamic financial services.

176. This can be achieved by holding individual sessions with the interested institutions or regular sessions under the innovation office of SECP. Further, collaboration in entrepreneurial competitions at CEIFs (IBA, LUMS, IMSciences).

5.3.2 Offer Islamic only cohorts under the regulatory sandbox initiative

177. To encourage institutions to test innovative ideas in real but controlled environment, consider offering Islamic only cohorts under the regulatory sandbox initiative. It has been reported during interaction with industry that under the regular cohorts, the Islamic products get lessor attention due to dominance of conventional players and products in the industry. Hence, in order to focus on Islamic only financial products, dedicate cohorts under the regulatory sandbox initiative will be fruitful.

5.3.3 Awareness sessions on the Guidelines for Offering Islamic Financial Services, 2023

178. To facilitate the institutions intending to offer Islamic financial services, SECP issued the Guidelines for Offering Islamic Financial Services, 2023, covering the concepts of Islamic windows, guidance for preparing and implementing plans for conversion of conventional institutions into Islamic institution and guiding principles for product development and governance. Hence, there is a strong need to hold awareness sessions on the guidelines to educate the stakeholders.

5.3.4 Develop a foundational framework for monitoring Shariah compliance

179. A framework for monitoring Shariah compliance within the institutions including Modarabas and at the regulator's level is essential. This will help the institutions improve Shariah compliance and enhance their standing as Islamic financial institutions. Developing standard operating procedures and checklists and consolidating all reporting obligations in one place will also help the institutions and the regulator improve Shariah compliance. Furthermore, because Shariah compliance is an added layer for institutions providing Islamic financial services, its structure must be refined so that it can be incorporated into regular compliance functions while reducing overall costs.

5.3.5 Start publication of a quarterly bulletin on Islamic finance

180. In line with the quarterly Islamic banking bulletin of SBP, SECP to start publish a quarterly bulletin on

Islamic finance. Through this publication, not only the facts and data relating to Islamic finance within non-bank financial sectors will be compiled, but also recent developments in the non-bank sector will be shared with stakeholders. Using them or taking a lead from them, the institution may either improve existing services offered by them or offer new services. In a nutshell, it will mean an improvement in overall Islamic financial services.

5.4 Strengthen the legal and regulatory framework for Islamic finance

181. A robust legal and regulatory framework for Islamic finance is essential for the development of Islamic finance in the non-bank financial sector, as presently, with the exception of the Modaraba sector, all other regulated sectors are governed through laws and regulations with a primary focus on the needs of conventional finance and enabling provisions for Islamic finance that are limited, restrictive, or in many cases absent altogether. In order to strengthen the legal and regulatory framework for Islamic finance, following are some specific recommendations, -

5.4.1 Promulgate dedicated Islamic finance law

182. To provide statutory cover to all regulated Islamic financial services in Pakistan, it is imperative to initiate working on developing a dedicated and full-fledged primary law for Islamic financial industry within non-bank financial sector in Pakistan. The proposed law, that may be called Islamic financial services act, may consolidate all the relevant provisions in one piece of legislation while serving a reference point for development of case laws in judicial system. The proposed law will encapsulate development of Islamic financial products from the need to wrap the Islamic concepts into conventional framework e.g. developing commodity Murabaha as "futures contract", reflecting Murabaha as financing tool instead of trading where holding inventory is possible, etc. The primary law will also serve as basis for developing a parallel structure of capital market institutions capable of replacing the conventional market and achieving Islamization of financial system and economy.

5.4.2 Amend the Modaraba Law to create flexibility and ease of doing business

183. The existing Modaraba law do not contain the required flexibility for the use of Modaraba vehicles for new business models at small scales or for gradual or subsequent scaling-up of the same. Aside from vigorously pursuing the Modaraba Ordinance (Amendment Bill) 2022 for promulgation, which will undoubtedly include necessary enabling provisions, there is a need to develop the concept of subsidiary legislation under the amended Modaraba law. This will also provide, required insight to identify the scope and potential of the Modaraba sector. Because amending the primary law will take time, until the promulgation of the Modaraba Ordinance (Amendment Bill) in 2022, necessary changes may be implemented by amending the Modaraba Rules, where possible. Further, there is a need to consolidate and refine the regulatory requirements for Modarabas prescribed through circulars or directives, and therefore one consolidated circular may repeal all existing circulars issued to date. The objective here is to improve the regulatory environment for the Modaraba sector as soon as possible.

5.4.3 Revamp Shariah governance regulations, 2018

184. Through consensus and coherent approach, revamp Shariah governance regulations, 2018, while addressing long-outstanding issues and conflicts. Key issues include stock screening criteria of AAOIFI and KMI, matters concerning transparency and disclosures and application of regulations on collective investment schemes.

5.4.4 Revamp Shariah advisors' regulations, 2017

185. To enhance the quality of Islamic financial services in regulated sectors and to consolidate scattered requirements of Shariah advisors in different regulations, recognizing boards formed under SBP framework, there is need to revamp the regulations. Subsequent changes in the other regulations governing public offerings, Takaful and NBFCs may also be required.

5.4.5 Introduce Shariah governance framework for Islamic mutual funds

186. Shariah governance framework is very important to ensure that the Islamic financial services offered by the asset management companies in the form of mutual funds or by the pension fund managers in the form of pension funds are truly Shariah-compliant. Presently, there is no regulatory guidance or oversight available for the industry, which is negatively impacting the credibility of the sector as a whole.

5.4.6 Concept of Tier-I and Tier-II instruments for non-banking Islamic financial institutions

In line with the products available in the Islamic banking industry of Pakistan, a product of Tier-I and Tier-II instruments for Non-Banking Islamic Financial Institutions should be introduced to meet minimum equity and capital adequacy requirement.

5.5 Action Plan

187. An action plan, dividing the finalized recommendations into short-term, medium-term, and long-term segments, will be formulated separately while identifying the key stakeholders and the actions required by them. However, it will be done once a broad consensus of stakeholders has been reached on the policy recommendations. Further, the action plan with also augmented the recommendations made in the independent assessment being carried out by IFAAS separately.

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