

ISLAMIC BANKING IN PAKISTAN

Islamic Banking in Pakistan: A Review of Conventional and Islamic Banking

Prof. Dr. Khawaja Amjad Saeed

Hailey College of Banking and Finance

University of the Punjab, Lahore

Terminology

IBIs	-	Islamic Banking Institutions.
ND	-	No Date
NIB	-	Non – Interest Based Banking.
NPFs	-	Non – Performing Finance
P	-	Page.
PP	-	Pages
PTC	-	Participation Term Certificate
ROA	-	Return on Assets.
ROE	-	Return on Equity.
SBP	-	State Bank of Pakistan.
SME	-	Small & Medium Enterprises.
TFC	-	Term Finance Certificate

Prelude

The rise of Islamic Banking is a welcome sign. However, at present, conventional banking and Islamic Banking (IBIs) are operating on a parallel basis in Pakistan.

This piece examines some interesting aspects for analysis of Conventional Banks and IBIs.

Constituents

This piece consists of the following parts:

Part	Focus
I	Quranic Guidance and 1973 Constitution of Pakistan.
II	Historical Rundown and Developments For IBIs In Pakistan.
III	Growth, Development & Performance of IBIs in Pakistan.
IV	Conclusion & Recommendations For Future Growth

The above aspects are now explained below.

The data were extracted from Islamic Banking Bulletin released by the Islamic Banking Department of SBP in June 2011.

Part I: Quranic Guidance and 1973 Constitution Of Pakistan

Quran and Elimination of Interest

Allah has forbidden taking interest and has guided everyone to do business, trade and profession.

In this respect, based on our research, some Quranic Verses are quoted below:

“Those who consume interest cannot stand [on the Day of Resurrection] Except as one stands who is being beaten by Satan into insanity. That is because they say “Trade is [just] like interest”. But Allah has forbidden interest. So whoever has received admonition from his Lord and desists may have what is just, and his affairs rests with Allah. But whoever, returns [to dealing in interest or usury] – Those are Champions of the Fire they will be abide eventually therein”. [Al-Quran: 2-275]

One of the basic cardinal principles of being a true Muslim is a firm belief in Hereafter and on the Day of Resurrection. If these thoughts are indoctrinated in ones mind, no Muslim will follow Satan and consequently avoid coming into a state of mind characteristicly described with insanity. Accordingly, in the above verses Allah has guided us as Muslims to stay away from taking interest. Those who are living under the misperception that interest is akin to trade are totally mistaken. Consequently, Allah has admonished us in this respect. If those of us do not believe in these thoughts, they are destined to be the Champions of Fire and will be delivered to the Hell for ever to eventually live there.

It is therefore, required on our part that we as stakeholders must undertake all steps to eliminate interest from our economic and social life at the earliest. Under the 1973 Constitution of Pakistan, it is obligatory on the part of the Government of Pakistan (Article 38 (f)) to eliminate Riba as soon as possible. The Government must rise to this occasion and accept this as a challenge and meet their Constitutional obligation.

Another Quranic Verse is as under:

“Allah destroys interest and gives increase for Charity. And Allah does not like every sinning disbeliever”. [Al-Quran: 2-276]

Based on above, Allah has encouraged giving charity and destroying interest.

In another Quranic Verse, Allah has said:

“O you who believe, fear Allah and give up what remains [due to you] of interest if you should be believers”. [Al-Quran: 2-278]

Muslim as believers, based on above Quranic Verse, must give up interest and follow the orders of Allah.

Another Quranic Verse in respect of above thought shared by Allah in Al-Quran is quoted below:

“And if you do not, then be informed of a war [against you] from Allah and His Messenger but if you repent, you may have your principle – “Thus” to no wrong nor are you wronged”. [Al-Quran: 2-279]

Allah in the following Quranic Verse has also ordered that we should not consume usury in any shape. We must always fear Allah so that we may succeed in life. In this respect, a Quranic Verse is quoted below:

“O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful”. [Al-Quran: 3-130]

Usury has been understood to be high or super high rate of interest charged by financial and other institutions.

Another Quranic Verse regarding taking usury is quoted below:

“And [for] their taking of usury while forbidden from it and their consuming of the peoples wealth unjustly and we have prepared for the disbelievers among them a painful punishment”. [Al-Quran: 4: 161]

The foregoing verse from Al-Quran contains a strict warning of painful punishment for those who take usury which Allah has forbidden. Their act in taking usury constitutes consuming of the peoples wealth in an unjust manner and for them there will be a painful punishment.

In another Quranic Verse, Allah has said:

“And whatever you give for interest [i.e. advantage] to increase within the wealth of people will not increase with Allah. But what you give in Zakat, desiring the countenance of Allah – Those are the multipliers”. [Al-Quran: 30-39]

Based on above, Allah has again guided us to give up interest and has encouraged giving Zakat as He will, through his infinite wisdom and blessings, introduce multipliers in respect of giving Zakat.

Riba and 1973 Constitution of Pakistan

The present democratic Government is taking pride in claiming that they have restored the 1973 Constitution of Pakistan in its original shape. Accordingly, they deserve congratulation. However, the crying need of today is to implement the above Constitution in letter and spirit. In this respect, an excerpt from Article 38 (f) of the above Constitution is quoted below:

“The State shall Eliminate **Riba** as early as possible”.

There is a need to implement the above spirit of the Constitution as 39 years have already passed and the Nation is eagerly awaiting the happy moment when **Riba** will be totally eliminated from our social and economic life to usher in an era of Islamic Society where dividends can be reaped by the common man and all other persons across the board in our country.

Part II: Historical Rundown and Developments for IBIS in Pakistan

Historical Rundown

During the 64 years of the history of Pakistan some efforts, at times casual, at times half hearted, at times with speed, have been made to eliminate **Riba**. In this respect, the following Table contains salient features of the efforts made in the past:

Table: 1

Efforts to Eliminate Riba from the Socio-Economic Landscape of Pakistan

Decade	Main Effort
1970s	Some efforts started with no conspicuous results.
1980s	Bold and comprehensive initiatives were undertaken. Pakistan was ranked amongst the three countries of the world for commencing non-interest based banking. Various legislations (Companies Ordinance, 1984, Negotiable Instruments Act, 1882, State Bank Act and Recovery of Loans Laws etc. were reviewed to bring these in line with the tenants of Islam. A new interest free Instrument namely; PTC (Participation Term Certificate) for Corporate Financing was introduced and was later replaced with TFC(Term Finance Certificate). Non-Interest Based Instruments (NIB) Numbering 12 were announced. In the Conventional Banks separate interest free counters were opened on January 01, 1981. For meeting working capital needs of trade and industry, Musharaka was introduced on July 01, 1982. Profit and loss sharing basis was introduced in Conventional Banks on April 01, 1985.
1990s	In November 1991, Federal Shariat Court was established. An announcement

	was made on December 23, 1991 that transactions involving interest in banks would cease to have effect finally by June 30, 2001.
21 st Century	Commission for Transformation of Financial System was constituted in State Bank of Pakistan. Task Force was set up in SBP to suggest ways and means to eliminate interest from Government financial transactions. However, parallel banking system namely; Conventional and Islamic Banking has continued till today.

State Bank of Pakistan Role

Islamic Banking Department was established in the Central Bank of the country namely; State Bank of Pakistan (SBP). Clear-cut statements in respect of Vision and Mission were announced. These are reproduced below:

Vision and Mission Statements of SBP. “To transform SBP into a modern and dynamic Central Bank, highly professional and efficient, fully equipped to play a meaningful role on sustainable basis in the economic and social development of Pakistan. To make Islamic Banking role, the banking of first choice for the providers and users of financial services”.

Mission Statement. “To promote monetary and financial stability and foster a sound and dynamic financial system, so as to achieve sustainable and equitable economic growth and prosperity in Pakistan. To promote and develop Islamic Banking industry in line with best international practices, ensuring Shariah compliance and transparency”.

Vision and Mission Statements of Islamic Banking Department of SBP are given below:

Vision and Mission Statements of Islamic Banking Development of SBP

- 1) *Vision Statement.* “To make Islamic Banking, the Banking of **First Choice** for the providers and users of financial services”.
- 2) *Mission Statement.* “To promote and develop Islamic Banking industry with the “Best International Practices” ensuring Shariah compliance and transparency”.

Strategy for Islamic Banking in Pakistan

Globally two strategies are recommended. The first one is known as Revolutionary strategy which Iran followed in respect of introduction of Islamic Banking. The second one is evolutionary strategy which Pakistan announced for introducing Islamic Banking in the country.

Simi par approach is being followed in Indonesia and Malaysia

State Bank of Pakistan has developed the following three point strategies relating to development of Islamic Banking in the country. These include the following:

- 1) Full-fledged Islamic Banks are encouraged to be established in Pakistan on independent footing. The objective was to help develop Islamic Banking away from the parallel run of Conventional and Islamic Banking.
- 2) The above category of Islamic Banks established, at (1) above have been permitted to establish their subsidiaries throughout Pakistan.
- 3) The Conventional Banking set ups in Pakistan were permitted to establish Stand Alone Islamic Banking Branches in Pakistan.

Accordingly, SBP hopes that, through the evolutionary process, while Islamic and Conventional Banks may continue on parallel basis, efforts were initiated to introduce Islamic Banking in the country. However, as will be shown later in the Statistical Analysis, the pace of converting Conventional Banks to Islamic Banks is very slow. A breakthrough effort is the crying need if

Allah's command to eliminate interest from the society is implemented with true spirit and with committed and dedicated efforts.

PART III: PERFORMANCE OF Ibis IN PAKISTAN

The Rise of IBIS

We have tabulated the growth of IBIs. Three indicators selected include Total Assets, Deposits and Net Financing Investment.

Table 2

Growth of Islamic Banks:

Some Important Indicators (December 2003- to June 2011)

Year (December)	Total Assets		Deposits		Net financing investment	
	Total Rs.b	Share of IBIs %	Total Rs.b	Share of IBIs %	Total Rs.b	Share of IBIs %
2003	13	1	8	1	10	1
2004	44	2	30	1	30	1
2005	71	2	50	2	48	2
2006	119	3	84	3	73	2
2007	206	4	147	4	138	4
2008	276	5	202	5	186	4
2009	366	6	283	6	226	5
2010 (June)	411	6.1	330	6.4	236	4.6

2011 (June)	560	7.3	452	7.6	420	7.0
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Source: Extracted from: Islamic Banking Bulletin, Karachi: State Bank of Pakistan, June 2011

The following conclusions emerge from the above table:

- 1) IBIs represent 7.3% of banking industry.
- 2) IBIs share of deposit was 7.6% and the share in net financing investment was 7.0% of banking industry.
- 3) Shares of all the three indicators have been registering a steady rise. This augurs well for the IBIs for the future.

The following Table has been compiled to present concentration analysis of Islamic Banks in Pakistan as on June 30, 2011:

Table: 3

Concentration Analysis of IBIS Branches by Districts

Name of District	Number of Branches	%
Karachi	223	28
Lahore	133	17
Islamabad	43	05
Bahawalpur	41	05
Faisalabad	35	04
Peshawar	32	04
Multan	27	04
Quetta	25	03
	559	70

Others	240	30
Total	799	100

There are over 100 districts in Pakistan. Unfortunately, Islamic Banking Branch Network exists only in 73 districts. Therefore, there is need to widen the network of branches in every district, tehsil and union council of each Province of Pakistan, particularly in rural areas so that those who are desirous of opening their accounts and also undertaking their operations in Islamic Banking modes can really benefit out of it.

A detailed analysis has been carried out by us and the following Table presents IBIs branch network:

Table 4

Islamic Banking Branch Network in Pakistan

S. #	Particulars	Number of Branches	%
A:	Islamic Banks		
	1. Meezan Bank Ltd	232	
	2. Al Baraka Islamic Bank	87	
	3. Bank Islami Pakistan	70	
	4. Dubai Islamic Bank	66	
	5. Dawood Islamic Bank Ltd	42	
	Sub-Total	497	62

B:	Islamic Branches of Conventional Banks		
	1. Bank Alfalah Ltd	80	
	2. Faysal Bank Ltd	37	
	3. Askari Bank Ltd	29	
	4. Habib Bank Ltd	22	
	5. Bank of Khyber	21	
	6. Others	64*	
	Sub-Total	253	32
C:	Sub-Branches of IBIs		
	1. Bank Islami Pakistan Ltd	32	
	2. Dawood Islamic	08	
	3. Others Banks	09**	
	Sub-Total	49	6
	Total	799	100

*Standard Chartered (15) MCB Bank (14), Bank Al Habib (10), UBL (7), Soneri Bank (6), NBP (8), Habib Metropolitan Bank (4).

**The Bank of Khyber (3), AlBaraka Islamic Bank (2), Askari Bank (2), MCB Bank (2).

Source: Extracted from: State Bank of Pakistan, Islamic Banking Bulletin, Karachi, June 2011

Annexure, P. 24.

By Allah's grace, the growth of IBIs branches has been steadily increasing as is shown in the following Table:

Table: 5

Growth of Islamic Banks Branches

December 2003 to June 2011

Year (December)	Number	Base Index	Number of Times
2003	17	100	1
2004	48	300	3
2005	70	412	4
2006	150	882	9
2007	289	1,700	17
2008	515	3,029	30
2009	651	3,829	38
2010 (June)	667	3,924	39
2011 (June)	799	4,582	47

Source: Extracted from: Islamic Banking Bulletin, Karachi: State Bank of Pakistan, June 2011.

An analysis, based on three categories of IBIs is presented below:

Table 6

Islamic Banking Branches Network

As on June 2011

Particulars	Branches	
	Number	%
A: Full Fledged Islamic Banks	497	62
B: Islamic Branches of Conventional Banks	253	32
C: Sub-Branches	49	06
Total	799	100

Source: Extracted from: Islamic Banking Bulletin, Karachi State Bank of Pakistan, June 2011 Annexure, P.24

DEPOSITS OF IBIS

As on June 30, 2011, a sum of Rs. 452 b represented deposits of IBIs. The following Table sums up the overall position and sources of deposits:

Table 7

Deposits: Islamic Banking Industry

As On June 30, 2011

Particulars	Rs. b	%
A) Customers	<u>Rs. b</u> 423*	<u>%</u> 94

-	Fixed Deposit	:	163	39
-	Saving Deposit	:	150	33
-	Current Account		108	24
	Non-Remunerative	:		
-	Others	:	02	04
			<u>423*</u>	<u>100</u>

B)	Financial Institutions		29	06
			<u> </u>	<u> </u>
	Total:		<u>452</u>	<u>100</u>

C)	<u>Break UP – Currency-Wise</u>			<u>%</u>
➤	Local Currency Deposits		433	96
➤	Foreign Currency Deposits		19	04
			<u> </u>	<u> </u>
	Total:		<u>452</u>	<u>100</u>

Customers represents 94% of deposits. However, the other source namely; financial institutions has yet to be exploited. IBIs coverage from foreign currency deposits is very low. This also represents an area to be explored to their advantage.

IBIs Financing

A sum of Rs. 199.2 b represented IBIs financing as on June 30, 2011. The following table presents break up in respect of above.

Table 8
IBIs Financing Products
June 30, 2011

S. No.	Products	Rs.b	%
1.	Murabaha	90	45
2.	Diminishing Musharaka	63	32
3.	Ijarah	23	12
	Sub-Total	176	89
4.	Others (Istisna: Salam, Musharaka, Mudarba)	23.2	11
	Total	199.2	100

Source: Extracted from: Islamic Banking Bulletin, Karachi State Bank of Pakistan, June 2011, Table 4, P. 5.

A comparative analysis of IBIs financing based on sectoral composition with banking industry is tabulated below:

Table 9
IBIS Financing: Sectoral Composition (June 2011)

S.#	Sector	IBIs%	Industry
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			%
1.	Textile	20.40	17.70
2.	Individuals	15.80	11.30
3.	Energy: Production & Transmission	8.50	10.10
4.	Chemical & Pharmaceuticals	6.90	3.80
5.	Sugar	4.90	3.20
6.	Cement	3.40	2.20
	Sub-Total	59.90	48.30
7.	Other Sectors (Including 34.41% for industry and 17.29% for industry others)	40.10	51.70
	Total	100	100

Source: Extracted from: Islamic Banking Bulletin, Karachi State Bank of Pakistan, June 2011, Table 5, P. 5.

Five sectors constituted around 60% of IBIs total financing. Textile industry (20.4%) was the main beneficiary, followed by individuals (15.8%) and remaining main sectors which benefited included energy (8.5 %), chemical and pharmaceuticals (6.9 %), sugar (4.9%) and cement (3.4%).

Due to energy crisis in the country, industries are operating at lower capacity and thus IBIs are in difficulty to collect the money lent.

Non-Performing Finances (NPFs) of IBIs It is generally agreed that NPFs should not exceed 4% of advances. Unfortunately, this trend is growing and stands un-arrested in conventional and Islamic banks.

The crying need is to keep it to most minimum level. In this respect, the following Table presents the position as on June 30, 2011:

Table: 10

Break UP of NPFs of IBIs

As On June 30, 2011

S. No.	Particulars	Rs.b	%
01	Doubtful	2.3	15
02	Sub – Standard	2.2	15
03	Loss	10.4	70
Total:		14.9	100

The following Table presents time series of NPFs:

Table 11

IBIs NPFs Time Series

Period	NPFb
	Rs.b
December 2008	3.4
December 2009	10.0

December 2010	13.8
June 2011	14.9

Source: Extracted from: Islamic Banking Bulletin, Karachi: State Bank of Pakistan, June 2011, Table 8, P. 7.

It would be apparent from the above Table that NPFs are rising. Perhaps due to liquidity problems of beneficiaries, it is becoming difficult to collect the money lent. Due to critical shortages of energy and uncertainty dominating economic policies, NPFs are becoming a headache for banking industry in general and IBIs in particular.

IBIs Investments

A sum of Rs. 231 b stood invested by IBIs on June 30, 2011. The following table shows the composition of investment:

Table 12

IBIs Investments: Composition

As on June 30, 2011

Composition	Rs. b	%
1. Federal Govt Securities	148	64
2. TFCs, Debentures, Bonds & PTCs	29	13
3. Fully Paid up Ordinary Shares	2	1
Sub-Total	179	78
4. Others	52	22

Total	231	100
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Source: Extracted from: Islamic Banking Bulletin, Karachi: State Bank of Pakistan, June 2011, Table 6, P. 6.

It is interesting to note that 64% of investments stood invested in Federal Government Securities. This represents risk free principal with assured and guaranteed rate of return. The remaining amount was mentioned to have been invested in several products including debentures which is not Shariah compliant.

Only 1% was invested in equity shares. Currently volumes are thin and trading on Stock Exchanges in Pakistan is slow. Available floats of blue chips are small and except for a few scripts, share prices show declining trends.

Highly specialized and magnificently qualified professionals are needed to guide IBIs to help develop their investment strategies.

IBIs: Earning & Profitability Analysis

From three angles, we have analyzed the performance of IBIs and banking industry namely; income, expenses, and spread. The following table presents the position in a summarized shape:

Table: 13

IBIs: Earnings and Profitability

As On June 30, 2011

Indicator	IBIs %	Industry %
A) Income		
Net Income to Total Assets (RAA)	1.60	1.40

Return on Equity (ROE)	16.50	14.40
Net Interest Income to Gross Income	82.60	75.90
Trade & Fx Gains (Losses) to Gross Income	5.30	7.60
B) Expenses		
Operating Expenses to Gross Income	60.90	51.00
Personnel Expenses to Operating Expenses	36.10	37.20
C) Spread		
Spread between Financing and Deposit Rate	8.80	6.90

It is apparent from the above Table that IBIs have performed better than the banking industry based on the following three indicators:

- 1) Net income to total assets (ROA).
- 2) Return on equity (ROE).
- 3) Net interest income to gross income.

However, income earned from trade and foreign exchange to gross income is lower. This potential needs to be tapped and the source of income needs to be expanded.

Table 14

Selected Performance Indicators: IBIs & Banking Industry

As on June 30, 2011

S. No.	Particulars	IBIs%	Industry%
1.	CAPITAL		
	Capital to Total Assets	9.2	9.4

2.	ASSETS QUALITY RATIO		
	NPFs to Financing	7.50	15.30
	Net NPFs to Net Financing	3.20	5.50
	Provisions to NPFs	60 .00	67.90
	Net NPFs to total Capital	14.30	26.60

Part IV: Conclusion & Recommendations For Future Growth

Suggested Investment Portfolio Mix for IBIs

In 2010, the then Deputy Governor of State Bank of Pakistan, while presenting a keynote address in an International Conference in Lahore outlined three points strategy for the guidance of IBIs. In this respect, our suggestions for investment portfolio mix by IBIs are as under:

1) Agriculture Sector

- Agriculture sector has yet to be served by IBIs and unfortunately represents largely unserved. It constitutes 22% of GDP of Pakistan However, based on data released by SBP, IBIs financing concentration in agri-business as on June 30, 2011 was only 2.80% of their total financing as against 6.10% of industry, which too is also very low. IBIs need to train and develop a new breed of bankers to swing into action in rural heart of Pakistan and invest in agri-business with particular emphasis on small farmers so that poverty can be reduced, agriculture output may attain a quantum jump, expand exports of agri-based products, ensure food autarky and help develop a sense of confidence on self-sufficiency on agricultural front. It may be noted that agricultural sector has four components, namely;

Table: 15

Agricultural Components In Pakistan

S. No.	Component	%
01	Livestock	54
02	Crops – major and minor	43
03	Fish	02
04	Forestry	01
		100

An in-depth study of above can guide the IBIs to develop a strategy to select the sub-components within the above framework.

There is also a crying need to develop agro-based industries i.e. Tomato Paste, Potato Processing, Cold Storages etc. to which IBIs need to direct their efforts for financing.

2) *SME Sector*

- It is estimated that total SMEs in Pakistan are around 3.1 million. Out of this, it is generally believed that 2300 clients are being served in terms of financing by IBIs. There is an urgent need to address SMEs and divert their financing to this sector so that employment generation takes place, industrial output increases and poverty is tackled and alleviated in the short run and eventually eliminated in the long-run.

- The outreach to small towns and rural / semi-rural areas be tapped for achieving foregoing laudable objectives.

- IBIs need to develop trained manpower to address the above issues They must accept this challenge.

3) *Housing Finance*

- It is believed that six million housing units deficits exist in Pakistan. There is a need to develop shelter policy in Pakistan so that untapped market be exploited and IBIs may render useful service of diverting their funds to this area and thus help meet one the basic needs of the common man. This agenda be pursued with speed so that their tangible support brings some peace of mind to common man.

Forecast

1. In the next five years, 1200 branches of Islamic Banks are visualized to be opened. The hope is that IBIs will be 12% of total banking industry in due course of time.
2. By 2013, total of Islamic Banking industry is forecasted as Rs. 1 trillion.
3. Determined efforts are needed by all of us to push forward the process of Islamic Banking in Pakistan and taper off conventional banking and water down its impact.

Challenges

We visualize the following future challenges:

1. Suggestions offered throughout this paper be given proper attention for implementation to ensure a sound foundation of IBIs in Pakistan.
2. *Differentiated products* be developed. Some Islamic Banks have taken correct initiatives in this respect. This areas needs to be logistically well cushioned with demonstrated results.
3. Islamic Banks must shown **growth with profitability**. The top management must evolve the process to translate the above challenges.
4. 15,000 **people** are needed in the next five years to equip Islamic Banks. In this respect, Universities in Pakistan must respond to this challenge. Curricula must be changed in

management education. High Education Commission should provide motivation in this respect for Universities to positively respond.

5. *Sharia compliant* financial services be expanded. Awareness be created in this respect and logistics be developed as cushion to achieve the above objective.
6. The scope of services for users may be extended to such areas as micro finance, agriculture and small & medium enterprises. This will widen the base of socio-economic development in our country and will address to the two vital issues in our country namely, promotion of self employment opportunities and alleviation of poverty.

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