



## Legal Foundations for Shariah-Compliant Islamic Banking in Pakistan: Challenges and the Way Forward

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### Abstract:

#### Abstract

The Islamic banking industry in Pakistan has grown significantly, yet it faces critical challenges related to its legal and regulatory foundations. This paper presents a qualitative analysis of the existing primary laws that administer the Islamic banking industry, focusing on the legal cover these foundational laws provide and the inconsistencies that arise from their fragmented nature. Based on nine in-depth interviews with experts in banking, Shari'ah, academia, and law, this study examines how the industry faces multifaceted juridical challenges and the potential way forward. The existing banking fundamental laws like the Banking Companies Ordinance, 1962 (BCO), the Financial Institutions (Recovery of Finance) Ordinance, 2001 and the SBP Act, 1956 do not effectively address the legal and administrative disputes of the industry due to which the industry often tries to adopt alternate disputes resolutions. Similarly, the Shari'ah Governance Framework (SGF) is effective from January 01, 2025. The administrative bodies like the Islamic Banking Department (IBD) and the Shari'ah Advisory Committee of the SBP lack legal backing in these primary laws. Moreover, these primary laws do not dictate the banking judges and the legal counsels to resolve the issues of the Islamic banking institutions (IBIs) on Islamic principles of business and finance nor are the existing cape of the judges capable of deciding matters of the industry on such principles. The capacity building of the SBP and IBIs poses legal hurdles in transforming the economy according to the Constitution article 38(f) and the judgment of the Federal Shariat Court. The recent amendment by the parliament in the BCO has made the ongoing transformation of conventional banking into Shari'ah-based more difficult because it has given silent approval to the traditional system of banking by incorporating Part-II under section 39 which made the BCO more legally conflicting. The research explores the historical neglect and non-Shari'ah-compliant embeddedness of the legal framework over the last four decades in contrast to the perpetual but inconsistent development of the regulatory framework. This institutional

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behaviour left the two foundational frameworks legally mismatching and even conflicting. The study provides a roadmap about the proposed Shari'ah-based promulgation of the legal and regulatory frameworks that legally support operations of the industry keeping in view the Higher Objectives of Shari'ah. The findings offer valuable insights for legislators, policymakers, regulators, and industry stakeholders on the way forward to strengthen the legal foundations of the Islamic banking industry in Pakistan.

**Keywords:** *Islamic banking, Legal framework, Regulatory framework, Shari'ah compliance*

## Introduction

This is a legal analysis of regulatory and legal frameworks of the Islamic banking industry that how much these fundamental frameworks are legally embedded in the primary laws like the Banking Companies Ordinance 1962, the Financial Institutions (Recovery Finance) Ordinance, 2001 and the State Bank of Pakistan Act, 1956. It also analyses the legal cover that these primary laws provide to the existing Shari'ah-compliant banking industry.

The Shari'ah-constitutional experts consider article 38(f) of the constitution of 1973 main source from where both the regulatory and legal frameworks draw their legal execution. A few of constitutionalists consider that all articles of the constitution are equal in legal binding force unless it is mentioned contrary. The others are of the view that the whole chapter of Principles of Policy is subject to the availability of adequate financial, social, human resources which provide the constitutional moral binding to be implemented. The said article is a part of the Principles of Policy (PoP) whose binding authority among constitutionalists is divided. They believe that without the availability of sufficient resources, PoP is not more than a vision of the state-machinery. Article 30(2) explains that the validity of an action or law shall not be called in question based on that such law or action is not in conformity with the PoP.<sup>4</sup>

The National Assembly has recently passed a bill under the title of Banking Companies amendment Act, 2024. It carries some basic definitions of Islamic banking, and its various products which are applicable to the IBIs. Following is the detail of the recent legal developments made to the BCO on October 31, 2024:

### 1. Recent Developments

Several legal developments are made in the last months of October and November 2024. The future role and lagging points of these developments are provided in the following sections.

#### 1.1 Incorporation of Part-IIA in BCO

A separate Part-IIA under section 39 sub sections A-M a total 13 provisions are added to the Banking Companies Ordinance, 1962 as Islamic banking on October 19, 2024. This part of the bill is suggested by the SBP to be incorporated as a substantive part of the legal framework. This is a formal recognition of the dual system of banking in the country the Shari'ah-compatible banking in contrast to the conventional banking system. This recognition of the dual system of banking has provided right thumb to the conventional system which was declared prohibited by the Federal

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<sup>4</sup> Constitution of Islamic Republic of Pakistan 26th Amendment Included. 1973

Shariat Court through its judgment on April 28, 2024.<sup>5</sup> To make the two streams of banking distinct, section 26A and its four sub-sections 26A 1(i),(ii),(iii), (2), (3), (4) are made exceptional to the Islamic banking system. Under these sections conventional banks are managing their business. When a legal expert read the updated version of the BCO becomes confuse about which sections are applicable to which banking system and why? A lack of clarity and legal flow is created in the ordinance. Under section 39 sub section A to M in thirteen subsequent sections Islamic banking and its products are defined. Again it is mentioned that this section and its sub-sections are only applicable to IBIs and to conventional banking institutions (CBIs). Instead of complicating legal matters, it would be more suitable if the law making authorities to develop a dedicated Shari'ah-based legal framework. This means that the updated version of the BCO carries three kinds of laws. Laws equally applicable to both types of industries, only applicable to the CBIs and only related to the IBIs. No criteria is fixed which law is why or why not applicable to a particular industry. This legal complications and ambiguities financially and legally affected both streams of banking systems.<sup>6</sup>

## **1.2 Introduction of the Shari'ah Governance Framework**

According to the Strategic Planning (2021-2025), the State Bank of Pakistan issued an updated and more comprehensive version of the Shari'ah Governance Framework on November 22, 2024 by making amendments in the SGF 2018. The new SGF will be effective from January 01, 2025.<sup>7</sup> Moreover, the IBIs are directed to make necessary arrangements of strict compliance and submit its report by March 31, 2025. From the comparison of both the frameworks, the newly issued SGF 2025 is more consolidated the SBP's regulatory role to overcome the regulatory flaws and administrative weaknesses or loopholes that were hindering the financial growth of the industry.<sup>8</sup> The SGF 2025 is more legally and administratively solidified in twenty aspects. It provides a more dominant regulatory role to the SBP as compared to SGF 2018. The SGF2025 binds every IBI for the following necessary arrangements:

Appointment of the Chairperson and Resident Shari'ah Board Member (RSBM). Periodic meetings of the Shari'ah Board (SB) on online and at least one physical meeting of the members. Recording the minutes of every meeting of SB and communicating to the SBP. Executive body of every IBI is responsible to communicate to SB each legal and information technology development. The executive body is also responsible to keep the standard nomenclature maintained. The new SGF also explains a detail procedure for the appointment of Shari'ah board members. It also mentions that one Shari'ah board member will serve in one board and not more than one. It binds IBIs for the establishment of compliance department and maintaining its regular training.

## **1.3 Theoretical Framework**

This research work has analyzed the three different frameworks, the legal, the regulatory and the statutory frameworks for their legal cum moral and religious misalignments. The analysis

<sup>5</sup> Federal Shariat Court Judgment 2022." edited by Federal Shariat Court Islamabad Pakistan, 2022

<sup>6</sup> Nosheen, and Abdul Rashid. "Financial Soundness of Single Versus Dual Banking System: Explaining the Role of Islamic Banks." *Portuguese Economic Journal* 20 99-127.

<sup>7</sup> SGF. "Shariah Governance Framework." edited by The State Bank of Pakistan, 2025.

<sup>8</sup> Saba, Iram. "Islamic Banking and Finance in Pakistan." 2023.

is based on the available literature for finding out the religious and socio-economic impacts of the provisions of the foundational laws. The fundamental role of the SBP as a central regulator is to direct the regulatory framework for the inculcation of administrative reforms and business code of conduct based on the principles of *Maqāsid al-Sharī'ah* in the form of subordinate legislation.

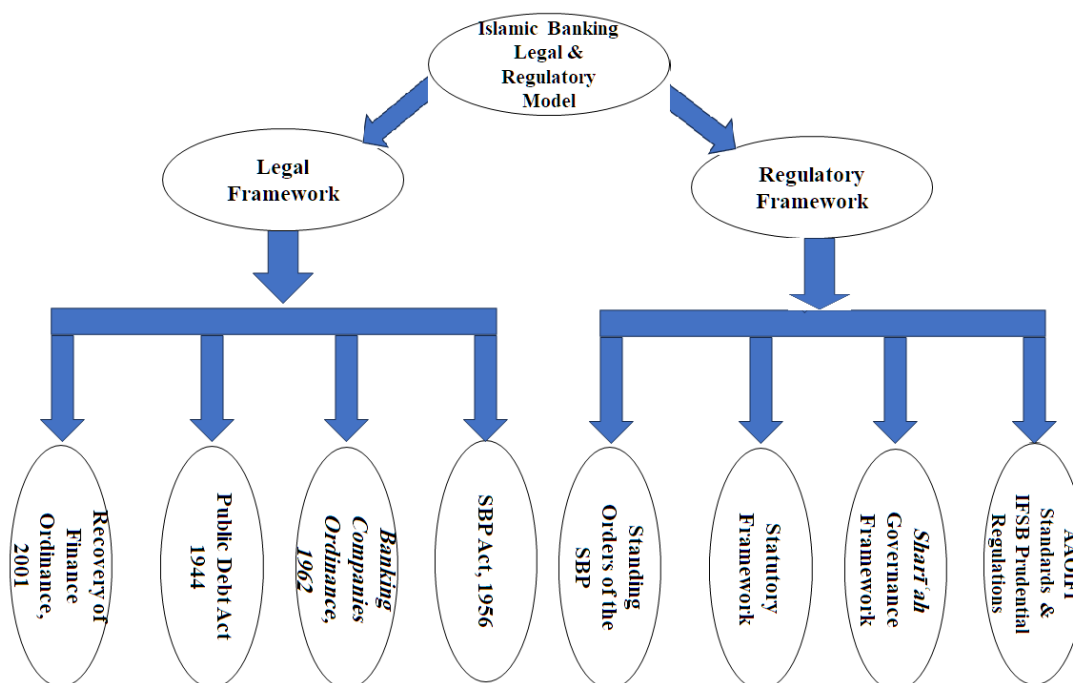


Fig. 1. Theoretical Model

## 2.1 Literature Review

This literature review examines key research works related to the legal framework of Islamic banking in Pakistan. The review is based on influential works by renowned scholars such as Muhammad Taqi Usmani, Abbas Mirakhor, Muhamed Zulkhibri Abdul Majid, Iram Saba, Dr. Muhammad Umer Chapra, Muhammad Nejaullah Siddiqi, Dr. Tahir Mansoori, Dr. Muhammad Dr. Iqbal Shahzad Sham, Asghar Shahzad and Dr. Muhammad Abubakar, Muhammad Khaleequzzaman along with various research papers and policy briefs.

Nejatullah Siddiqi (1996), in his book “The Role of State in the Economy, an Islamic Perspective” supports that economy including banking industry should be in the control of Islamic state. The state has to provide economic and financial guidelines to the public and private institutions. Administering monetary policy matters is the domain of Islamic state solely.

Muhammad Umer Chapra (2005), in his book “Towards New Monetary Policy” and “Regulation and Supervision of Islamic Banks” (occasional paper 2000) suggests that the Objectives of Shariah can only be achieved by issuing a balanced, Islamic welfare monetary policy by the Islamic state. The author gives authority to the State Bank to regularize the business of commercial and investment banks through a proper legal framework and to provide them conducive environment for financial growth.

Muhammad Kabir Hassan (2009) in his research work highlighted that Islamic banking system has unique nature that requires proper legal regulatory framework and regulators to

evaluate related risks and benefits. According to him the industry should not be let freely in the hand of accountants, financial engineers or conventional regulators. Otherwise the industry may suffer with grievous financial crises as we have observed for many times at global level.

Abbas Mirakhor (211) an academicians and expert in the field of globalization of Islamic finance. In his works "Globalization and Islamic Finance" and "Regulatory Framework for Islamic Finance" regarding issues related to globalization of Islamic finance he has pointed out some challenges to Islamic finance as risk management and transfer of technology. He did not discuss how to incorporate the solution to these two major challenges in the legal framework of the banking industry. Pakistani Islamic Banking Industry also faces the same issues which need to be investigated. In connection to the importance of a compatible and conducive legal framework the author has claimed that a regulatory framework is mandatory to minimize the abuse financial contracts and transactions by the industry. Havis Aravik (2021) in his article "The Role of the State in the Islamic Economic System: A Review of Abbas Mirakhor's thought" concluded that Abbas Mirakhor proposes the productive role of state in achieving the welfare of public through effective regulation of the monetary and economic policies of the state-institutions.

Muhammed Zulkhibri Abdul Majid's (2012) work on "Comparative Analysis of Islamic Banking Supervision and Regulation Development" claims that regulatory framework is needed for financial stability of the industry. He says that the primary legislation is taking place in perspective of the conventional banking system. Due to the absence of proper legal framework a dedicated Islamic banking is missing in the country to properly guide the industry on Islamic patterns of trade and business. According to the author, to harmonize the industry practices demand for a dedicated legal framework in every country where Islamic banking industries want to compete their conventional counterparts in a productive way.

Maulana Muhammad Taqi Usmani (2014), a renowned Shariah scholar, and also plays a key role in framing the Shariah governing framework of the industry in his works "An Introduction to Islamic Finance" and "Islamic Finance: Principles and Practice," provides an exhaustive understanding of the fundamental principles of Islamic finance. These works explore concepts such as prohibition of interest, profit and loss sharing, and asset-backed transactions. His academic contributions offer a sustainable foundation for the development of Islamic banking and finance in Pakistan. Maulana Taqi Usman could not focus issues regarding the legal framework of the industry although he play active role in pursuing the prohibition of *Riba* case at different levels. Which can be counted as practical contribution in re-framing the existing legal framework of the industry.

Engku Rabiah Adawiah Engku Ali (2017) in research article "Towards an effective legal and regulatory framework for Islamic financial transactions: Major initiatives of the Central Bank of Malaysia" advises that reforms in the legal framework cannot be over-emphasized in case when such framework/laws comes to an end-to-end Shariah compliant framework and consumer protection. In the case of Malaysia the advice may be appropriate where the legal framework of the industry is end-to-end Shariah compliant but in Pakistan it may not be claimed that the legal framework of Islamic Banking Industry is completely end to end Shariah compliant.

Muhammad Ayub (2019) "Enhancing the Competence and Effectiveness of Shariah Advisory Boards: Case of Islamic Banking Institutions in Pakistan" insists on the enactment of a conducive and Shariah compatible legal framework for the Islamic Banking Industry of Pakistan. Seedy Conteh (2022) "Regulatory framework of Islamic finance in selected West African countries," the author reports about the poor political and legal backing along with the absence of a comprehensive legal framework has weaken the Islamic Banking Industry in the selected

Western African countries. The author suggests, strong political support along with a comprehensive legal framework may give leverage to the industry's development on long terms. Murvat Sardad Khan (2023) "The Legal Framework for Islamic Banking: Pakistan's Experience", proclaims that in his book (chapter 18) that Islam has its own system of economics. It regulates individuals' economic activities as well as the economic activities of institutions. Islam does not allow institutions to regulate themselves on the standards other than prescribed by Islam. In Pakistan an effective legal regulatory framework is needed to regulate the Islamic Banking Industry according to principles of Islamic finance.

Shahzad Iqbal Sham (2020), "The Constitutional, Legal and Current Status of Islamic Banking and Finance in Pakistan" has discussed the ideological roots of Islamic banking and finance in Pakistan. He has dugout the roots of Islamic banking and finance in the policy statement of the Founder of the nation, Quaid-e-Azam Muhammad Ali Jinnah which he gave on the annaguration ceremony of the State Bank of Pakistan 1948, the speech of the founder of the nation in Islamia College Peshawar 1946, the Objectives Resolution 1948, the Constitution of 1973 article 31, 31 (2c), 227 (1), referring to the decision of the Federal Shariat Court decision in 1990, the decision of the Shariat Appellate Bench of the Supreme court of Pakistan on the appeal filed against the decision of the Federal Shariat Court of Pakistan. The author did not discussed the legal framework of the Islamic Banking Industry upon which the industry is running from last three decades.

## 2.2 Framing the Legal and Regulatory Issues

Basically Islamic banking system is established on the principles of Musharakah and Mudarabah contracts of Islamic finance. Form the movement of Pakistan and to its creation along with the assurance of the Constitution, 1973 article 38(f), the Objectives Resolution 1949, on every legal, political, and constitutional turning, the nation was promised that the system of this country will be run according to the injunctions of the Quran and Sunnah.<sup>9</sup> To Islamize the economy and banking system a gradual approach was adopted in the late 1970s when several amendments carried out by the by the Zia regime in legal framework of the banking industry. This gradual Islamization process was may be an effective approach but it was too much slow process and even in more than forty years it could not achieve its basic objectives.<sup>10</sup>

From the late 1980s to the beginning of 2002, all legal measures that were taken to produce a Shari'ah compatible legal framework for the banking industry. The purpose of the Shari'ah compatible legal framework was to legally re-engineer the existing banking products and processes with the purpose to avoid public directly indulging in Riba-based profit earnings. The

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<sup>9</sup> Tauheed Ullah, Siddiqui, Musa Muhammad, and Yusoff Dr. Syarah Syahira Mohd. "A Critical Analysis of a Thirty-Five Year Judicial Interplay in Riba Case." *Journal of Business and Management Research* 3, no. 1 (2024), Resolution, Objectives. "The Constituent Assembly of Pakistan Debates." edited by The Constituent Assembly of Pakistan Debates. The Constituent Assembly of Pakistan Debates: The Constituent Assembly of Pakistan Debates, 1949.

<sup>10</sup> Rammal, Hussain G, and Lee D Parker. "Islamic Banking in Pakistan: A History of Emergent Accountability and Regulation." *Accounting History* 18, no. 1 (2013): 5-29. Zafar, Muhammad Bilal, and Ahmad Azam Sulaiman. "Islamic Banking in Pakistan: Emergence, Growth, and Prospects." In *Growth and Emerging Prospects of International Islamic Banking*, 61-77: IGI Global, 2020.

first evolution phase of the Shari'ah compatible legal framework of Islamic Banking industry starts from the efforts when Zia regime introduced Profit ad Share (PLS) accounts in all branches of banks in the country in 1980. Although the PLS accounts were resembling to the conventional accounts but the regulator wanted to provide a way out to public as an alternate to impermissible earnings from conventional modes of banking products based on *Riba*, *Gharar* and *Mayser*.<sup>11</sup> This was a quite slow paradigm-shift which opened the doors for the private banking institutions to shoulder the long waited Islamic banking system in the country.

Introducing Islamic banking system in a private capacity in Pakistan on public demand was the continuation of the process of Islamization of economy in 2002. The 2<sup>nd</sup> evolutionary phase of the Shari'ah compatible legal framework starts with the official recognition legal and financial status of Islamic banking industry as an alternate and partially independent banking system under the umbrella of the State Bank of Pakistan (SBP) to the interest-based conventional banking system in the country. The SBP started to re-engineer the existing conventional regulatory framework to meet the temporary financial and administrative needs of Islamic banks and its customers. It started issuing regulations and standing orders for running the business of Islamic banks but in dispersed and disorganized form which had no alignment with the legal framework of the industry.<sup>12</sup>

The SBP focused more than what was needed on the regulatory framework. In the meanwhile the legal framework was left untouched for its legal and moral development. The SBP did its level best by shaping the conventional regulatory framework into a Shari'ah-compliant one. This led the industry to a misconception in the eye of public which started believing that now onwards the banking industry has become Islamic. Neither the SBP nor the legislators focused the legal framework for its legal developments equal to its regulatory framework on principles of Islamic finance.

This behavior caused a big legal gap between the legal and the regulatory frameworks. At this phase of the legal framework is Shari'ah Compatible as it was in the late 1980s but the regulatory framework is legally grown to a Shari'ah-compliant status. The SBP through regulatory framework made the existing Islamic banking products rarely conflicting to the Shari'ah basic principles of finance.<sup>13</sup> These regulations and banking products can easily attract clients. In current phase of evolution, the regulatory framework is Shari'ah compliant but the legal framework is still Shari'ah compatible. Instead of the regulatory framework Shari'ah compliance which is functional from the last two decades but the ignorance of legal framework due to which Pakistan is still one of the eleven Muslim countries where the Islamic banking industry is running on the domicile laws

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<sup>11</sup> Calder, Ryan. "Shari'ah-Compliant or Shari'ah-Based? The Changing Ethical Discourse of Islamic Finance." *Arab Law Quarterly* 35, no. 1-2 (2020): 50-73. Sham, Shahzad Iqbal. "The Constitutional, Legal and Current Status of Islamic Banking & Finance in Pakistan." *The Islamic Culture "As-Saqafat-ul Islamia" الثقافة الإسلامية-Research Journal-Sheikh Zayed Islamic Centre, University of Karachi*, no. 20 (2009).

<sup>12</sup> Farooq, Mohammad Omar. "Islam Compliance, Beyond Shari'ah Compliance: Toward a Broader Socio-Economic Transformation." *Arab Law Quarterly* 1, no. aop (2022): 1-43

<sup>13</sup> Mohammad Omar Farooq, "Islam Compliance, Beyond Shari'ah Compliance: Toward a Broader Socio-Economic Transformation," *Arab Law Quarterly* 1, no. aop (2022).

of the country.<sup>14</sup> The State Bank of Pakistan administers Islamic banking by issuing standing orders, circulars and regulations approved by the Islamic banking Department (IBD).

The SBP has its Shari'ah Advisory Committee (SAC) which is responsible to look after the compliance of Islamic banking institutions (IBIs). Although SAC has no legal status and SBP is legally not bound to follow its advice on issues related to Islamic finance. Not only the SAC but the whole Islamic Banking Department of the SBP has no legal backing in any primary legislation like the SBP Act, 1956 and the BCO, 1962. Still SAC guides the Islamic banking industry in Shari'ah related complications.<sup>15</sup> This 2<sup>nd</sup> evolutionary phase which was started from April 20, 2002 on the launching of Meezan Islamic Commercial Bank Pvt. ended on October 19, 2024 when article 38(f) and Banking Companies Ordinance, 1962 was positively amended by the parliament.<sup>16</sup> According to the amendment in the Principles of Policy now the state is responsible to eradicate *Riba* by January 01, 2028

The general public consider that these two amendments have revolutionized the case of recognition of Islamic banks as legally alternate industry to the conventional counterparts. Legally these two amendments were not meant to eradicate *Riba* from the banking system rather it was intended to give a safe way to conventional banking system. The BCO amendment recognized dual system of banking in the country. Before the amendment conventional banking was ordered by the FSC to be abolished but now whatsoever is the gradual transformation of banking system will be continued. Instead of all these reservations the first constitutional amendment which is done to the article 38 (F) of the Principles of Policy stated in the Constitution, 1973 was a landmark amendment which configured the jurisdiction of the article to a time limit of January 01, 2028 that *Riba* will be eradicated from the economy of the country. This amendment provided concrete legal foundations to the establishment of Islamic banking industry. Although the chapter of Principles of Policy has no such binding like the other articles of the constitution but still it binds government morally to act in accordance to the spirit of its articles. If this amendment was made to a substantive part of the constitution then it would be constitutionally binding like its other articles but still the amendment is clear in its wording instead of the previous article in it was mentioned in words as soon as possible.

The 2<sup>nd</sup> legislative amendment that was carried out to the Banking Companies Ordinance, 1962 by adding a chapter of banking provisions about Islamic banking industry to the ordinance. This amendment was proposed by the SBP which was added to the BCO a great achievement in the history of evolution of legal framework. Although these two amendments will not change the status of the existing legal framework from a Shari'ah Compatible to the Shari'ah-based legal framework. These two amendments will pace up the legislative development of the legal framework a bit compatible to the existing regulatory framework which was lacking its legal

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<sup>14</sup> Khan, Mohsin S, and Abbas Mirakhor. "Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan." *Economic development and cultural change* 38, no. 2 (1990): 353-75.

Majid, Muhamed Zulkhibri Abdul, and Reza Ghazal. "Comparative Analysis of Islamic Banking Supervision and Regulation Development." *Money and Economy* 6, no. 3 (2012): 114-62.

Muneeza, Aishath, Ismail Wisham, and Rusni Hassan. "The Paradox Struggle between the Islamic and Conventional Banking Systems." *Journal of Asia Pacific Studies* 1, no. 2 (2010).

<sup>15</sup> Wasim, Sahibzada Muhammad Jan, Ahmad Azam Othman Bin, and Waqas Farooq. "Regulatory Arrangement for Shariah Governance Practice of Islamic Banking Institutions in Pakistan: Issues and Challenges." *Hitit İlahiyat Dergisi* 20, no. 1 (2021): 167-94.

<sup>16</sup> Tribune. "Mufti Taqi Usmani Lauds Elimination of *Riba* through 26th Amendment." *The Express Tribune*, 2024.

backing in the legal framework.<sup>17</sup> These two amendments have enhanced the Sharī'ah compatibility statuses of the legal and regulatory frameworks. These amendments have winded up the thirty-five years judicial interplay between the Federal Shariat Court and the Supreme Court Shariat Appellate Bench.<sup>18</sup> The legal efforts which are done to the existing banking laws are continuously evolving the legal and regulatory frameworks. If these legal and constitutional efforts were kept upright in future then it will lead us to the enactment of dedicated Sharī'ah-based legal framework.<sup>19</sup>

The absence of the aforementioned Sharī'ah-based legal framework has caused a grievous legal deficiencies in the regulatory framework. This subordinate legislation possess lesser authority and low degree legitimacy because most of its regulations do not find legal backing in the primary legislation. Besides this, inconsistencies can be found between the legal and regulatory frameworks which decrease a bit more its legal and moral binding. In the current scenario, mostly the primary legislation like the State Bank Act 1956 and Banking Companies Ordinance 1962 are fundamentally inconsistent with the regulatory framework. The regulatory framework which is issued by the SBP as one of the form of monetary policy instruments that possess specific jurisdiction. It cannot be treated equal to legal framework which is enacted to deter unlawful transactions that endanger public interest like financing terrorism. The second function of the legal framework is to bind public for doing some actions like paying taxes on their transactions.<sup>20</sup>

The inconsistencies between the legal and the regulatory frameworks have created issues of legal backing for any subordinate legislation by the SBP. Although the recent amendments in the BCO have recognized the different products of Islamic banking industry but still none of the primary banking laws explicitly urge for the establishment of dedicated Sharī'ah-based Islamic banking industry.<sup>21</sup> Rather the primary legislation like the Banking Companies Ordinance, 1962 and the SBP Act, 1956, encourage interest-based banking transactions and give complete legal protection in the form of a detail recovery procedure for the interest-based funds in cases of default of clients. On the other hand the subordinate legislation strictly discourages interest-based banking transactions and furnishes alternate regulations in the form of financial penalties for indulging in non-Islamic banking transactions. On the parallel the regulatory framework also facilitates the

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<sup>17</sup> BCO. "The Banking Companies Amendement Act, 2024." edited by The Senate of Pakistan. The Senate of Pakistan, 1962.

<sup>18</sup> Siddiqui Tauheed Ullah, Musa Muhammad, and Yusoff Dr. Syarah Syahira Mohd, "A Critical Analysis of a Thirty-Five Year Judicial Interplay in Riba Case," *Journal of Business and Management Research* 3, no. 1 (2024).

<sup>19</sup> Calder, Ryan. "Sharī'ah-Compliant or Sharī'ah-Based? The Changing Ethical Discourse of Islamic Finance." *Arab Law Quarterly* 35, no. 1-2 (2020): 50-73.

<sup>20</sup> Bell-James, Justine, Rose Foster, Miguel Frohlich, Carla Archibald, Claudia Benham, Megan Evans, Pedro Fidelman, *et al.* "Not All Conservation "Policy" Is Created Equally: When Does a Policy Give Rise to Legally Binding Obligations?". *Conservation Letters* (2024): e13054., Yackee, Jason Webb, and Susan Webb Yackee. "From Legislation to Regulation: An Empirical Examination of Agency Responsiveness to Congressional Delegations of Regulatory Authority." *Admin. L. Rev.* 68 (2016): 395.

<sup>21</sup> Zakir, Muhammad Hamza, Nida Khan, Muhammad Sadan, and Syed Hammad Khan. "Legal Challenges in Islamic Banking and Finance in Pakistan: A Corporate Perspective." *International Journal of Contemporary Issues in Social Sciences* 2, no. 3 (2023): 264-74.

default funds of the customers. Although its recovery procedure is not so effective like the conventional recovery procedure which is backed by several primary legislations.<sup>22</sup>

The legal framework has clear stance about the recovery of default funds in the case of conventional banks but has no clear guidelines about the recovery of funds which are defaulted by the customers of Islamic banks. Their recoveries are left for ethical measures, leniency and social welfare urges. Besides this there is no treatment for the interest mentioned in the case of Islamic banks recoveries. That is why mostly Islamic banks avoid to adopt the conventional measures of recovery. These banks seek Alternate Dispute Resolutions (ADR) measures that is to recover their funds and to avoid interest earnings.<sup>23</sup>

Pakistan is although a member state to the IFSB and AAOIFI standards but still it did not adopt all the international standards of both the organizations. From the total 54 AAOIFI standards, SBP has adopted only 35 standards.<sup>24</sup> Being signatory to these standards it is the moral cum legal responsibility of the legislature to accommodate these standards through primary legislation in the form of legal framework. SBP as NRA to propose amendments in the legal framework accordingly to legally accommodate these international standards by means of dedicated primary legislation as the environmental regulatory authority did through 26<sup>th</sup> constitutional amendment bill.<sup>25</sup>

Adopting these international financial standards through regional law-making process will also reduce the number of litigations that arise from the Shari'ah non-compatible practices of IBIs.<sup>26</sup> This basic legislation will clarify the level of independence of the SBP and its parameters of its original jurisdiction as a national regulatory authority in issuing regulations, standing orders and circulars to the Islamic banking industry. It is important to legally analyze conversion of conventional banks to Islamic banking system to save the industry from legal mishaps. To legally analyze that mere public demand of conversion of the conventional banks into Islamic provides sufficient legal validity of conversion or not?<sup>27</sup> There a problem of legal responsiveness arises between the primary banking statutes and the subordinate regulations of the SBP.

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<sup>22</sup> Alam, Nafis, Sara Sophia Binti Zainuddin, and Syed Aun R Rizvi. "Ramifications of Varying Banking Regulations on Performance of Islamic Banks." *Borsa Istanbul Review* 19, no. 1 (2019): 49-64., Muneeza, Aishath, Nur Adibah Zainudin, Ruqayyah Ali, Siti Nadzirah Ibrahim, and Zakariya Mustapha. "Application of Ta'widh and Gharamah in Islamic Banking in Malaysia." *The Journal of Muamalat and Islamic Finance Research* (2019): 1-16.

<sup>23</sup> Rajper, Muhammad Aslam, Imtiaz Ahmed Memon, Liaqat Ali Abro, and Abdul Aghaffar Korai. "Investment and Recoveries Laws: Study of Modern and Islamic Banking of Pakistan." *GISRAS Journal of Management & Islamic Finance (GJMIF)* 1, no. 3 (2021)., Zulkifli, Hasan, and A Mehmet. "An Analysis of the Court's Decisions on Islamic Finance Disputes." *ISRA International Journal of Islamic Finance* 3, no. 2 (2011): 41-61.

<sup>24</sup> AAOIFI. "Accounting and Auditing Organization of Islamic Financial Institutions Standards." 2024.

<sup>25</sup> WHO. *Who Global Benchmarking Tool (Gbt) for Evaluation of National Regulatory Systems of Medical Products: Revision Vi*. World Health Organization, 2021.

<sup>26</sup> Eskander, Shaikh, Sam Fankhauser, and Joana Setzer. "Global Lessons from Climate Change Legislation and Litigation." *Environmental and Energy Policy and the Economy* 2, no. 1 (2021): 44-82.

<sup>27</sup> Faizy, Rasheed Ahmad. "Conversion of Conventional Banks into Islamic: State Bank of Pakistan (Sbp) Rules and Aaoifi Shari'ah Standards: A Critical Legal Analysis from the Perspective of Islamic

The existing banking laws have rare legal capacity to be altered anymore for accommodating IBIs.<sup>28</sup> Instead of enacting a dedicated Shari'ah-based legal framework by the parliament any further alteration for incorporating more legalism will restrict the productivity of the industry. Therefore, rebuilding the Islamic banking laws for providing legal backing to the already developed regulatory framework is mandatory instead of adding patches for accommodating Islamic financial modes of transactions.<sup>29</sup> Such dedicated law will provide clear legal mandate to the future and existing regulations. The loopholes in the current performance metrics of IBIs, regarding both sides of liabilities and asset will be covered. There will remain no objections of exploitation of accountholders and lower or middle level baking staff.<sup>30</sup>

Multiple issues of the existing legal and regulatory frameworks reveal that the misalignment between the two regulatory regimes has adverse effects on the acceptability by the public at large. Banking system affects the socio-economic and moral patterns of the society. This is political and regulatory duty of the government and the SBP to preserve such values of the society by making and implementing banking laws and regulations. Therefore, both the frameworks are qualitatively analyzed to for their adverse effects on the socio-economic and moral working patterns of the society.<sup>31</sup>

Keeping collaterals is also objectionable in Shari'ah point of view because *Rabul Maal* (the principal) has to take risk of investment. In case of negligence on the part of Mudarib can make him responsible otherwise not. Securities kept with SBP under Bai' Mua'jjal contract is also objectionable under the law of Islamic finance.<sup>32</sup> Any forward contract of such collaterals by the SBP amounts to unlawful contract.<sup>33</sup> SBP has to focus these issues and to amend the regulatory provisions accordingly. The existing legal framework encourages interest-based intra banks

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<sup>28</sup> Farooq, Mohammad Omar. "Islam Compliance, Beyond Shari'ah Compliance: Toward a Broader Socio-Economic Transformation." *Arab Law Quarterly* 1, no. aop (2022): 1-43.

<sup>29</sup> Menand, Lev, and Morgan Ricks. "Rebuilding Banking Law: Banks as Public Utilities." *Yale J. on Reg.* 41 (2024): 591.

<sup>30</sup> Ryandono, Muhamad Nafik Hadi. "Solution for Islamic Banks Exploitation: A Criticism of Fixed-Yields Based Financing in Indonesia." *Al-Uqud: Journal of Islamic Economics* 4, no. 1 (2020): 48-68., Yackee, Jason Webb, and Susan Webb Yackee. "From Legislation to Regulation: An Empirical Examination of Agency Responsiveness to Congressional Delegations of Regulatory Authority." *Admin. L. Rev.* 68 (2016): 395.

<sup>31</sup> Aldohni, Abdul Karim. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. Routledge, 2012.

<sup>32</sup> Maksum, Siti Nuraini. "Implementation of Mudharabah Principles in Sharia Leasing Products and Their Impact on Economic Justice." *Assets Journal: Journal of Economic and Business* 1, no. 2 (2023)., Nouman, Muhammad, and Karim Ullah. *Participatory Islamic Finance: Ideals, Contemporary Practices, and Innovations*. Springer Nature, 2023.

<sup>33</sup> Jamaludin, Jeniza, Normy Rafida Abdul Rahman, Nur Fadhilah Aziz, and Hari Krishnan Andi. "The Safe-Keeping Fee in Al-Rahn and Shariah Compliance." *Journal of Survey in Fisheries Sciences* 10, no. 1s (2023): 5848-57., Sriani, Endang, Farid Hasan, and Sukron Ma'mun. "Violation of Human Right for Collateral Fraud in Sharia Financial Institution Based on Fiduciary Guaranty Law and Rahn Law." *JURIS (Jurnal Ilmiah Syariah)* 22, no. 1 (2023): 133-43.

liquidity support. Due to the prevailing trend, IBs also provide liquidity support to weaker conventional banks even at high rates of interest by keeping interest-bearing government securities as collaterals. Same is the case of “Overnight Facilitation” by the SBP which is interest-based banking trend. In the case of IBs there is no such law that facilitates the SBP on interest-free basis.<sup>34</sup> That is why IBs do their transactions of “Overnight Facilitation” with SBP on interest basis in cases of rollover contracts of liquidity management. This means that there exists a conflict between theory and practice of IBs.

The regulatory framework does not clearly define the ratio between the statutory reserves and the cash reserves in the case of IBs.<sup>35</sup> Loopholes in the law have created the problem of excess of liquidity for IBs.<sup>36</sup> This excess of liquidity has compelled IBs to invest their non-working capital in less Shari‘ah compatible avenues through using a device of legal stratagems.

The legal framework governing the Islamic banking industry is inherently misaligned with its regulatory framework, as the operational mechanisms of the latter are diametrically opposed to the principles and stipulations enshrined in the former.<sup>37</sup> The financial approach of the first one is capitalistic while the approach of the later is distributive Islamic economic justice and collective socio-economic and moral welfare of the society. The existing legal framework does not legally represent Higher Objectives of Shari‘ah regarding finance rather it hinders their achievement and promotes capitalistic objectives through its legal working patterns.<sup>38</sup> For Islamic Banking Industry observing both the laws the conventional and Islamic may create legal and moral complexities especially adjudicating case of recovery for the bankers, legal practitioners, and the court itself.<sup>39</sup> Advance-to-Deposit Ratio (ADR) is also one of the issues of legal framework in the context of effective liquidity management by IBs.

Under circular number 01 of 2016, Islamic banks are given exemption from KIBOR rating in Musharakah, Mudarabah, and Wakalah based finance. IBs are still using KIBOR rate in financing in agriculture and industrial sectors. The use of KIBOR means that IBs are mere providing funds as loans to these sectors like the conventional banks. This means that IBs are not using the real modes of Musharakah, Mudarabah and Wakalah finance otherwise there would have

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<sup>34</sup> Zia, Uzma, and Fozia Tabussom. "Impact of Export Financing Schemes on Export Performance Qualitative Approach." Pakistan Institute of Development Economics, 2023.

<sup>35</sup> Sheikh, Nadeem Ahmed, and Muhammad Azeem Qureshi. "Determinants of Capital Structure of Islamic and Conventional Commercial Banks: Evidence from Pakistan." *International Journal of Islamic and Middle Eastern Finance and Management* 10, no. 1 (2017): 24-41.

<sup>36</sup> Islam, Amir, and Sabeen Amir. "Liquidity Problems in Islamic Banks; Reasons, Impacts and Solutions." *COMSATS Journal of Islamic Finance* 1, no. 1 (2016)., Alshammari, Turki. "Gcc Banks' Capital and Liquidity: Conventional Versus Islamic Banks." *Journal of Economic and Administrative Sciences* (2023).

<sup>37</sup> Mansoori, Muhammad Tahir. "Is" Islamic Banking" Islamic? Analysis of Current Debate on Shari‘ah Legitimacy of Islamic Banking and Finance." *Islamic Studies* (2011): 383-411., Siddiqui, Shahid Hasan. "Anatomy and Critique of Islamic Banking." *Pakistan Horizon* 65, no. 3 (2012): 35-58.

<sup>38</sup> Siddiqui, Shahid Hasan. "Anatomy and Critique of Islamic Banking." *Pakistan Horizon* 65, no. 3 (2012): 35-58., Zulkifli, Hasan, and A Mehmet. "An Analysis of the Court's Decisions on Islamic Finance Disputes." *ISRA International Journal of Islamic Finance* 3, no. 2 (2011): 41-61.

<sup>39</sup> Zakir, Muhammad Hamza, Nida Khan, Muhammad Sadan, and Syed Hammad Khan. "Legal Challenges in Islamic Banking and Finance in Pakistan: A Corporate Perspective." *International Journal of Contemporary Issues in Social Sciences* 2, no. 3 (2023): 264-74.

not any need of KIBOR rates.<sup>40</sup> Using KIBOR rate in participatory finance vitiates the participation of IBIs in such financing which make their financing similar to conventional banks.<sup>41</sup> The gap between theory and practice need to be addressed with legal measures for lowering the cost of banking products. To strengthen IBs transactions and remove these weaknesses from the legal framework is not the sole job of federal legislative council. Specific regulatory measures are also be required to ensure strict compliance of every product and service.<sup>42</sup> Therefore, a holistic and all inclusive primary and subordinate legislations is the collective duty of all organs of the state.

The recent Federal Shariat court's decision also emphasis on both types of legislations at provincial as well as levels. Gaps are needed to be investigated that how the provincial legislatures can help in the preparation of a Shari'ah-compatible legal framework for the banking industry on Islamic modes of business and finance. Provincial governments can identify the relevant areas which fall within their jurisdiction for legislation such as licensing and regulations, consumer protection and dispute resolution of Islamic banking industry being aligned to the local/provincial customs.<sup>43</sup> The primary legislation needs to be carried on priority bases because it carries the absolute will of the parliament and has legal cum moral binding on the Islamic banking institutions.<sup>44</sup> Formulating a unanimously agreed Shari'ah compatible legal framework for Islamic Banking Industry requires all the organs of the state to play their due role.

The present legal framework lacks the basic definitions of Islamic banking and does not guide Islamic banking industry in its business operations. In such situation, how can the SBP issue *Shari'ah*-compatible regulations to Islamic banking industry? Due to this legal lacking, the legal framework has no alignment with the regulatory framework. Even both frameworks are at 180° regarding the financial and socio-economic objectives.<sup>45</sup> Therefore, the legislature is required to align the legal framework to the regulatory framework by making Maqasid al- Shari'ah based banking and financial legislations.<sup>46</sup> The misalignment between the two frameworks is due to ignoring the legal framework by the Parliament and other responsible state entities for its

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<sup>40</sup> Ali, Azam, Tanveer Kishwar, and Muhamed Zulkhibri. "Islamic Finance and Participatory Financing Constraints in Pakistan." *Islamic Monetary Economics and Institutions: Theory and Practice* (2019): 89-108.

<sup>41</sup> QAYYUM, NOOR UL. "An Analysis of Interest Free Finance in Pakistan." *Available at SSRN 4130135* (2022)

<sup>42</sup> Zakir, Muhammad Hamza, Nida Khan, Muhammad Sadan, and Syed Hammad Khan. "Legal Challenges in Islamic Banking and Finance in Pakistan: A Corporate Perspective." *International Journal of Contemporary Issues in Social Sciences* 2, no. 3 (2023): 264-74.

<sup>43</sup> NFIS. "National Financial Inclusion Strategy." edited by Ministry of Finance Islamabad, 2023.

<sup>44</sup> Kramer, Matthew H. "On the Moral Status of the Rule of Law." *The Cambridge Law Journal* 63, no. 1 (2004): 65-97.

<sup>45</sup> Shaheen, Asma, and Muhammad Kashif Amin. "Bridging the Gap: Aligning Legal Frameworks with the Growth of Islamic Banking and Finance in Pakistan." *Journal of Business Insight and Innovation* 2, no. 1 (2023): 37-45.

<sup>46</sup> Ahmad, Zaki, Aishath Muneeza, Md Mahfujur Rahman, and Ziyaad Mahomed. "A Comparative Analysis of Shariah Governance Framework of Islamic Bank in Malaysia and Pakistan." *Talaa: Journal of Islamic Finance* 3, no. 1 (2023): 01-17., Habibullah, Mohammad, Abdullah Al Faruque, Md Omar Faruque, and Md Atiullah. "Islamic Economic Framework for the Exercise of Islamic Financial Activities: Its Conformity with Maqasid Shariah." *AL-BURHĀN: Journal Of Qur'ān And Sunnah Studies* 7, no. 1 (2023): 81-92., Fanshurna, Toton. "The Importance of Applying Maqashid Al-Sharia in the Islamic Financial System." *Journal of Islamic Economics Perspectives* 4, no. 1 (2022): 1-8.

consistent legal developments.<sup>47</sup> The SBP started developing the regulatory framework (RF) for meeting the regulatory needs of the industry through issuing cohesively unstructured and fragmented regulations. This was done to meet the legal requirements of the industry because developing the legal framework was not falling in the domain of the SBP. These fragmented, inter and intra non-coherent regulations caused the problem of inconsistent banking practices in the market. This two facet non-coherence hindered the conducive environment for the productive operations and legal development of the industry. There is legal uncertainty in the market about taking risk in different transactions by the Islamic banks.<sup>48</sup> The IBIs have adopted their own short ways of recovery of funds which are affecting the over-all image of Islamic banking industry. This legal imbalance in legislative preference of the regulatory needs over the legal needs of the industry created two major imbalances in the market. To meet the regulatory needs, the industry focused on the substance of the business operations. For this purpose, when the industry felt that it could not fulfill the regulatory needs by mere focusing on the substance of operations it started altering the working modes of transactions and banking products on the capitalist banking operations. This behavior of the industry caused confusions related to the legitimacy of IBIs operations in the mind of customers and Shari'ah scholars.<sup>49</sup>

The third problem which it caused in the industry is its enormous growth in the profit being ignoring the essence of Maqasid al- Shari'ah about the augmentation of wealth. This enormous development yielded to administrative problems within the industry like disproportionate distribution of the profit between IBIs and their customers especially with reference to saving deposits. The legal and regulatory frameworks both are silent about this unregulated behavior of the industry. This regulatory legal gap offered the industry opportunity of earning enormous profits being ignoring the objectives of socio-economic justice of Islam. Currently the legal framework is lagging too much behind the regulatory framework. Presently the regulatory framework has nurtured the industry in such a way that it becomes difficult to reshape it through a fresh Shari'ah-based legal framework. Its implementation will take long time to track the industry on Islamic socio-economic justice system.<sup>50</sup>

Therefore, the parliament needs to enact a dedicated legal framework in the form of parliamentary Act for providing legal cover to the Regulatory Framework, Shari'ah Advisory Committee and the Islamic Banking Department of the SBP. Now the whole industry is dependent on the discretion of the regulatory body which is a floating legal phenomenon.

## 2.3 Conclusion and Recommendations

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<sup>47</sup> Zahid, Mugheesa. "Islamic Banking in Pakistan: Legal Framework, Challenges and Growth Prospects." *Journal of Asian Development Studies* 12, no. 2 (2023): 17-28.

<sup>48</sup> Zakir, Muhammad Hamza, Nida Khan, Muhammad Sadan, and Syed Hammad Khan. "Legal Challenges in Islamic Banking and Finance in Pakistan: A Corporate Perspective." *International Journal of Contemporary Issues in Social Sciences* 2, no. 3 (2023): 264-74.

<sup>49</sup> Khaleequzzaman, Muhammad, Muhammad Tahir Mansoori, and Abdul Rashid. "Shari' Ah Legitimacy of Islamic Banking Practices in Pakistan-an Evaluation." *Journal of Islamic Business and Management* Vol 6, no. 1 (2016): 78-96., Siddiqui, Shahid Hasan. "Anatomy and Critique of Islamic Banking." *Pakistan Horizon* 65, no. 3 (2012): 35-58.

<sup>50</sup> Naqvi, Bushra, SKA Rizvi, Hina Ahmed Uqaili, and SM Chaudhry. "What Enables Islamic Banks to Contribute in Global Financial Reintermediation?". *Pacific-Basin Finance Journal* 52 (2018): 5-25.

The legal and regulatory frameworks of Islamic banking industry are inherently conflicting. The Legal framework does not provide a legal cover to all the transactions of Islamic banking industry. The dual system could not satisfy customers of the industry on the religiosity of Islamic banking modes of transactions. The spirit of the *Shari'ah*-based banking system is needed to be revived. Public perception is divided about some of the products and transactions of Islamic banking system. Religiosity of Islamic banking transactions are measured with the ratio of profitability of the industry which is the misunderstanding of the almost all researchers. The modes of transactions lack the legal, moral and economic higher objectives of *Shari'ah*. The 26<sup>th</sup> constitutional amendment could not provide a clear road map to the abolishment of *Riba* rather it sanctioned the dual banking system in the country. Although article 38(f) is restricted to a particular date January 01, 2028 but still it is a part of the "Principles of Policy" about which article 30 (2) states that no state authority shall be called in question on the basis that any of state action is not in accordance with Principles of Policy.<sup>51</sup> Therefore, it is needed to make the aforementioned article an equally binding part of the constitution. The recent amendment in the Banking Companies Ordinance, 1962 is insufficient in fulfilling the needs of Islamic banking industry. Amendments by the parliament in the BCO need to be incorporated to fill the huge gap of alignment between the legal and regulatory frameworks.

An empirical research is needed to evaluate the impact of the recent amendments done by the parliament to the article 38(f) and Banking Companies Ordinance, 1962 for analyzing how much these amendments have covered the gap of alignment between the two frameworks and how much these amendments will enhance the legal and financial worth of the industry.

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