

Growth and Challenges of Islamic Banking in Pakistan: A Comparative Analysis with Conventional Banking

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ABSTRACT

Islamic banking is considered to be one of the booming branches of the Pakistani financial system owing to the growing demand of the people towards Shariah compliant financial services, government backing as well as the rapid institutionalization. In this paper, the research will focus on the growth trend of the Islamic banking in Pakistan and compare its performance, customer image, the regulatory environment, and the operational issue with that of conventional banking. Through qualitative review of secondary data, the paper brings out the fact that Islamic banks have registered high asset growth, market share, and financial inclusion than was the case in earlier decades. Nevertheless, the problem of a limited product diversification, lack of Shariah-qualified professionals, increased operational expenses, and misconceptions among the people still limit the full potential of this. The comparison analysis shows that Islamic banking may prove to be more resilient and attractive, but conventional banks are more dominant because of better infrastructure and broader coverage. The paper ends with a conclusion and recommendations on how the regulatory support can be empowered, human capital boosted and consumer awareness can be enhanced to ensure sustainable growth of Islamic banking in Pakistan.

Keywords: Islamic Banking, Non-Shariah Banking, Shariah Compliance, Financial Development, Customer Perception, Pakistan Banking Industry, Regulation System, Problems.

INTRODUCTION

Islamic banking has been one of the most remarkable changes in the financial sector of Pakistan in the last 20 years and it has emerged quite fast in recent times. Islamic finance is a financial instrument based on the Shariah which forbids interest (riba), excessive uncertainty (gharar), and speculative deals (maysir). As a country with the majority of the population practicing Islam, Pakistan has been one of the primary actors in the global spread of the Islamic banking industry, and policymakers, scholars, and financial institutions have been encouraging offering Shariah-compliant versions of traditional interest-based banking (Ahmed, 2020). Islamic banking does not just go with the religious beliefs, but also Islamic banking is considered to be a way of encouraging ethical banking, financial inclusion and economic stability.

The contemporary Islamic banking in Pakistan began officially in the early 2000s when the State Bank of Pakistan (SBP) published a comprehensive regulatory model of the Shariah compliant banking. The scope of Islamic banking has since increased significantly, reaching up to double-digit growth rates and rising market shares in the banking sector (SBP, 2023). The SBP Islamic Banking Bulletin (2023) notes that the assets of Islamic banking have increased to more than 20 percent of the total banking sector assets indicating a growing level of trust among the public and institutional involvement. This expansion is facilitated by the development of full-fledged Islamic banks and the Islamic windows in the conventional banks. The banking model that has been applied in Pakistan is the dual-banking model where customers have a choice of either the Islamic or the conventional financial services which promote a healthy competition and innovation among banks.

Although Islamic banking in Pakistan has been growing impressive, it has been experiencing a number of structural and operational issues. The lack of authentic kinds of Shariah-compliant financial instruments, the lack of qualified personnel, regulatory hurdles, and misunderstandings by the lay population usually become a hindrance to the complete growth of the sector (Khan and Bhatti, 2019). In addition, the presence of established traditional banks poses extra pressure on the Islamic institutions to be innovative, cost efficient and satisfy clients. Thus, the comparison of the Islamic banking growth to the conventional banking development is the key to the comprehension of its recent performance, the perspectives, and policy requirements.

The importance of comparative research between Islamic and conventional banking lies in the fact that both systems are in the same environment, although they are rather different in terms of ideological basis, the mode of operation and value propositions. Traditional banking operates in the interest payment system, and Islamic banking deals in profit and loss-sharing systems like Mudarabah, Musharaka, and trade-related agreements like Murabaha and Ijara (Usmani, 2018). These differences can be used to determine how well Islamic banks can compete in a historical market where conventional models are dominating. According to a number of studies, customers are moving towards Islamic banking that has ethical underpinnings and sharing of risks (Awan and Bukhari, 2021). Some people however say that traditional banks are more effective when it comes to technology adoption, financial innovation, and accessibility of services.

Also, Islamic banking is strongly associated with Islamic socio-economic goals, including poverty reduction, justice in society, and fair wealth distribution. It is this that makes it a powerful model to be used by policymakers in the quest to achieve inclusive economic development (Iqbal & Mirakhor, 2017). In Pakistan, where a big section of the population is still unbanked or underbanked, the Islamic banking can increase the financial coverage by offering culturally fit and Shariah compliant financial services. Research indicates that Islamic microfinance and small business finance might significantly contribute to helping entrepreneurship and alleviating poverty (Farooq & Zaheer, 2020). Consequently, the implications of the study of the growth path of Islamic banking are not only in the financial sector but also in socioeconomic development in general.

Nevertheless, the industry still experiences a number of challenges which limit its development. Poor product diversification is one of the problems. In spite of the fact that Islamic banks provide Shariah-compliant alternative to traditional banking products, critics of Islamic banking complain that most of the Islamic products are almost similar to traditional banking products in their structure and performance, a

phenomenon that has been accused of Shariah arbitrage (El-Gamal, 2006). The other issue is the lack of skilled Shariah scholars and individuals specializing in Islamic finance thus impacting standardization and authenticity of products in different institutions. It is also problematic because operational inefficiencies and increased administrative expenses are in place, and Islamic banks demand more compliance levels, asset-backed financing models, and Shariah audit (Khan and Bhatti, 2019).

The regulatory environment is also core in defining the development of the industry. The State Bank of Pakistan (SB) has also implemented numerous policies to promote Islamic banking including Shariah governance systems, uniformity of practice, and training of professionals in the industry. However, the absence of Islamic financial instruments to manage liquidity and regulatory inconsistencies are still major impediments (SBP, 2023). The traditional banks have a competitive edge of better customer service and efficiency in their operations, as they are more mature, technologically developed, and experienced.

Considering these intricacies, it is important that a comparative analysis of the two banking systems should be done with the aim of determining their strengths, weaknesses, and chances of enhancing them. This analysis can also enable the policymakers and stakeholders to learn about the underlying forces that determine the customer preferences, the performance within an institution and the general trend in the financial landscape of Pakistan itself. Although Islamic banking has survived the recent global financial crisis, partly because of its principles of asset-backed and risk-sharing, traditional banking remains the leader in the number of overall market size, branch networks, and technological adoption (Hasan and Dridi, 2011).

This paper thus aims at discussing the development of Islamic banking in Pakistan, the weaknesses of the same, and comparing its performance to that of conventional banking. Through the review of literature, financial reports, and regulatory reports, the paper will provide information on the strengths and weaknesses of Islamic banking and give recommendations on the policy changes and institutional changes. The analysis is adding itself to the debates that are going on regarding the future of the Islamic finance in Pakistan and the possibility of it becoming a more competitive and socially responsible financial system.

LITERATURE REVIEW

Islamic banking and its growth and development have received significant scholarly concern over the last few decades, especially in the Muslim-dominated nations like Pakistan. Its historical bases, how it operates, its performance compared to other airlines and the issues that influence its development have been studied by scholars. The literature tends to underline the fact that Islamic banking is based on the concepts of Shariah that forbids interest (riba), undue uncertainty (gharar), and gambling or speculation (maysir). These taboos form the whole financial framework, and Islamic banking is in contrast to conventional banking that is essentially interest-driven (Usmani, 2018). According to the researchers like Iqbal and Mirakhor (2017), Islamic finance advocates a financial system that is ethical and socially responsible, founded on asset-based transactions, risk sharing and equitable wealth distribution.

Initial investigations were paid to the conceptual and theological resources of Islamic finance, emphasizing the significance of Shariah compliance and the impact of Islamic jurisprudence on the decision-making process in financial matters. According to Chapra (2016), the principles of Islamic economics are designed to create a fair financial system that helps to promote active business activities

and discourage exploitation of others as a result of charging interest on loans. These seminal studies developed a paradigm of appreciating the structuring of financing products in Islamic banks. To illustrate, Musharakah, Mudarabah, Murabaha, and Ijara are some of other forms of financing which do not require interest but may have a profit-sharing, mark-up based on trade, or lease structure (Ayub, 2019). This literature is the theoretical foundation to the analysis of Islamic banking practices in the world.

With the rise of Islamic banking around the world, the empirical research started to assess growth trends and performance of Islamic banking. The State Bank in Pakistan has been instrumental in institutionalizing the sector by coming up with regulations, Shariah governance policies, and banking reforms. SBP reports suggest that Islamic banking is expanding at a rate that is much higher than that of conventional banking over the last few years (SBP, 2023). Awan and Bukhari (2021) confirm that customer demand of Shariah-compliant financial products has been among the major sources of this expansion. According to them, the perceived ethical nature of Islamic banking and the growing awareness of consumers has enhanced the credibility and acceptance of the Islamic financial institutions. It is also noted in a few works that the dual-banking model in Pakistan, which involves the presence of Islamic and conventional banks coexisting, has prompted competition and innovation, which gave the customers the opportunity to select services that resonated with their values (Ahmed, 2020).

Another theme of the literature is the study of comparative performances of the Islamic and conventional banks. According to some studies, Islamic banks are resilient to the financial crisis because of their asset-backed characteristics and concepts of risk sharing. As Hasan and Dridi (2011) observe when analysing the 2008 global financial crisis, Islamic banks were not affected compared to the conventional banks since they were not exposed to the toxic assets and other speculative financial products. Equally, findings of study by Bourkhis and Nabi (2013) reveal that Islamic banks exhibited greater indicators of stability when compared to conventional banks in a time of financial distress. This implies that such structural differences between the two systems have financial stability implications.

Nevertheless, in terms of financial efficiency, profitability, and market reach, the traditional banks tend to be much better than the Islamic banks. Khan and Bhatti (2019) explain that traditional banks in Pakistan possess a better infrastructure and are larger in terms of network of branches and in terms of the sophistication of their technology system which gives them an edge. The major challenges that Islamic banks are facing despite the high growth rate include increased cost of operations and lack of product diversification. This necessitates a higher level of governance, auditing, and oversight due to the need to have Shariah compliance, which may add to administrative costs. Research by Iqbal and Llewellyn (2020) shows that Islamic banks find it difficult to reach economies of scale as conventional banks do particularly in developing countries where people lack financial literacy.

The other significant theme that has been identified in the literature is connected with customer perception and the aspects that affect the decision of choosing Islamic or conventional banking. It has been determined in research that religious commitment is one of the primary factors in preference of Islamic banking. One of the first studies in this field is by Metawa and Almosawi (1998) that discovered that the Islamic banks customers are highly influenced by their religious beliefs. This trend is confirmed by more recent studies in Pakistan. As an example, Hanif (2018) believes that the most influential factor when it comes to customers using Islamic banking services is their religious adherence. Nevertheless, he also states that service quality, accessibility, and financial returns become the issues that customers take

into consideration more and more. The study by Awad and Bukhari (2021) also concludes that despite the fact that a significant number of consumers study the Islamic banking branch due to its religious orientation, the level of satisfaction with service delivery and technological effectiveness is not consistent. This implies that Islamic banks cannot simply depend on the appeal to religion and not compete on quality and convenience.

The literature also determines that there are a number of structural challenges to Islamic banking in Pakistan. Inadequate availability of real Shariah-compliant financial instruments is also one major problem. Most modern Islamic financial products, El-Gamal (2006) notoriously holds, are more or less economic imitations of conventional banking products, which have been criticized by some as a form of Shariah arbitrage. This has been raised by different scholars who assert that Islamic banks at times practice profitability at the expense of true compliance to Shariah. The article by Usmani (2018) emphasizes the significance of rigorous Shariah governance systems and control to preserve the authenticity and exclude practices that are likely to distrust the population.

The second issue that has been extensively covered is the lack of qualified human resources. Islamic banking needs individuals that are knowledgeable in modern finance as well as Islamic jurisprudence and this is hard to get. According to Khan and Bhatti (2019), the absence of Shariah academics with financial experience can be listed among the gravest limitations of the industry development. This paucity is part of the discrepancies in Shariah decisions in institutions, which complicates standardization. The State Bank of Pakistan has tried to solve this problem by conducting training sessions and Shariah governance systems, but the number of qualified professionals is not enough (SBP, 2023).

The issue of liquidity management is also a frequent one in the literature. The Islamic banks have very rigid Shariah restrictions that limit the use of interest based financial instruments through which conventional banks make short term liquidity adjustments. This also limits the ability of the Islamic banks to effectively manage liquidity. Research literature like that conducted by Iqbal and Mirakhor (2017) indicates that the unavailability of Shariah-compliant liquidity instruments limits the capacity of Islamic banks to be stable and profitable. Even though the State Bank of Pakistan has launched sukuk (Islamic bonds) and other instruments to resolve this problem, researchers believe that the set of instruments available is still comparatively small to the ones that are available to the conventional bank (Ayub, 2019).

Another factor that has significant influence on the growth path of Islamic banking is public awareness and misconception. According to Farooq and Zaheer (2020), most consumers in Pakistan are not aware of how Islamic financial products operate resulting in confusion and mistrust. They claim that marketing, financial education, and transparency should be effective to increase the confidence of the populations. On the same note, research indicates that a section of the clients feel that Islamic banking is more costly than other regular banking owing to the cost architecture of Shariah-compliant products (Hanif, 2018). This perception, true or false, shapes the choice of the customers and has an impact on the ability of Islamic banks to grow.

When comparing the performance of Islamic and conventional banking systems, one can note that the literature indicates an ambivalent situation. On the one hand, the Islamic banks receive applause due to their ethical basis, stability, and capacity to conform to the socio-religious ideals. Conversely, they encounter some issues regarding efficiency, standardization, diversification of the products, and

regulation support. Bourkhis and Nabi (2013) also note the significance of building strong regulatory frameworks that should be specific to the special interests of the Islamic finance. On the same note, Ahmed (2020) writes that the momentum of Islamic banking in Pakistan requires government support, institutional reforms and financial innovations to continue.

In general, the literature implies that Islamic banking in Pakistan has come a long way but still has to overcome certain hurdles that can be solved to achieve long-term sustainability. Islamic banks are characterized by the comparative advantage of the ethical principles they follow, as well as the possibility to increase financial inclusion. Nevertheless, in order to compete successfully with traditional banks, Islamic financial institutions have to enhance service quality, operation efficiency, technological uptake and awareness to the population. Further regulation reforms, improvement of human capital and increase of Shariah-compliant financial instruments are imperative in toughening the sector. Taken altogether, the body of literature underscores the fact that even though Islamic banking has a good road ahead, the true potential of this financial establishment can be achieved only with the help of thorough-reforms, standardization of the industry and a number of strategic development projects.

METHODOLOGY

The current research will use qualitative research design using secondary data to examine the growth and challenges of Islamic banking in Pakistan and compare it to the conventional banking system. The most common areas of qualitative methodology in finance and social sciences are those where there is a need to comprehend patterns, institutional evolution and conceptual variation instead of quantitatively measuring relationships (Creswell, 2018). Qualitative analysis is suitable to provide a comprehensive and interpretive perspective of the phenomena which are being examined since the present research study will deal with structural, regulatory, and operational aspects of the Islamic and conventional banking.

The study is based on the secondary sources, such as the articles in academic journals, books on Islamic finance, reports issued by the State Bank of Pakistan (SBP), annual financial reports of banks, policy documents, conference papers, and related theses. Secondary data is thought to be appropriate in the comparative financial research due to the ability to analyze the long-term trends, the trends in regulations, and empirical research results that are already available in the literature (Johnston, 2017). Triangulation can also be conducted when secondary data is used and in this case, the data obtained in various sources is given a comparison that enhances the validity and consistency of findings. As an example, SBP reports on market share, asset growth, branch expansion and regulatory frameworks of Islamic banking were compared with independent academic reports in order to find out trends and inconsistencies.

Data collection was conducted by searching peer-reviewed journals in trustworthy databases including Google scholar, JSTOR, Researchgate, and ScienceDirect by searching terms Islamic banking in Pakistan, conventional banks performance, Shariah governance, Islamic finance problems, and banking sector growth. It was thought better to give priority to the studies published within the past decade to incorporate the trendy trend, and at the same time, basic literature on Islamic economics was incorporated where deemed appropriate. Also, the official statistics and regulatory insights were used by consulting the national reports, including SBP Islamic Banking Bulletin, financial stability reviews, and policy frameworks. These documents were very useful in terms of market share, institutional development, liquidity concerns, and customer preferences.

Thematic analysis was applied to analyze the data, which is a qualitative approach, which has been used to determine the repetitive patterns, themes, and concepts in the collected data (Braun and Clarke, 2006). The literature was used to derive the themes on an inductive basis and these themes were growth trends, customer perception, Shariah governance, liquidity challenges, product structures, technological adoption, and comparative performance. Both the Islamic and conventional banking were studied in relation to each theme and thus aspects of similarities, deviation, benefit, and drawback were identified. The thematic analysis can be used in the research since it enables the researcher to categorize the vast qualitative data into meaningful themes to facilitate more significant interpretation of the complex financial systems.

In order to make comparison of Islamic banking with conventional banking, a qualitative approach was taken comparatively. Financial research often employs comparative analysis to learn more about how various systems perform in the same regulated and economic context (Neuman, 2014). In this way, the researcher was able to look at the distinctions between Islamic banks and conventional banks in terms of mechanisms of operation, regulation restrictions, market penetration, consumer satisfaction and financial performance. As an example, traditional banking literature usually emphasises on efficiency, technological integration and cost structure, whereas Islamic banking literature has concentrated on Shariah compliance, ethical considerations and risk-sharing characteristics. With such views combined, one can have an objective assessment.

The reliability provided to the study is by triangulation of sources and by use of numerous academic and institutional publications. The review of various scholarly works, policy documents, and financial reports help the research to reduce the bias and even guarantee the balanced evaluation of the data. Another indicator of validity is the analysis of only the sources with credibility and authority, specifically, the SBP reports, the most significant source of official information on the banking sector in Pakistan (SBP, 2023). Moreover, the comparison of data given by different authors helps to minimize the power of personal opinions.

Although the qualitative method is very rich, conceptually clear, it also has its limitations. The use of secondary data is also one of the limitations as it might not reflect all the recent events or confidential issues that are encountered in banks. The secondary data can also be influenced by the subjectivity or the weakness of the first writers. The other weakness is that there were no primary sources like interviews or surveys that would have provided first hand information among customers, bankers and Shariah scholars. Nevertheless, primary data collection was not possible because of time and the scope of the research. Irrespective of such limitations, the abundance of academic literature and official reports makes the analysis complete and based on well-established findings.

On the whole, the methodological framework used in this paper is appropriate to the investigation of the complex character of Islamic banking and analysing its comparison with the traditional banking in Pakistan. The study provides an elaborate insight into the existing trends, structural issues and institutional relations by using secondary data, thematic analysis and comparative interpretation. The given methodology is a solid basis of the further discussion of the findings and it also makes a significant contribution to the overall scholarly discourse on Islamic finance.

DATA ANALYSIS AND FINDINGS

This section evaluates secondary data of academic sources, reports of the State Bank of Pakistan (SBP) and financial data in order to discuss the development and problems of the Islamic banking in Pakistan against conventional banking. The information is an indicative of the general market share, expansion of assets, branches, deposits, financing schemes, Shariah administration, liquidity control, and customer inclinations. Descriptive statistics in the analysis is combined with thematic interpretation to give a holistic view of the performance and shortcomings of both systems.

Islamic banking in Pakistan has manifested a fast growth over the past decade. The SBP Islamic Banking Bulletin (2023) notes that the assets of the Islamic banking sector had almost 20 percent of the total banking sectors assets as compared to only 3 percent in the early 2000s. The data indicate a steady rise in the market share, which is contributed by the customer awareness, the institutionalisation of the full-fledged Islamic banks, and introduction of the Islamic windows in traditional banks. The table below gives a summary of the development of the assets in Islamic banking in Pakistan using SBP reports.

Table 1: Growth of Islamic Banking Assets in Pakistan (2015–2023)

Year	Islamic Banking Assets (PKR Trillion)	Market Share (%)
2015	1.6	11.4%
2017	2.3	13.6%
2019	3.1	15.5%
2021	4.2	17.0%
2023	5.8	20.2%

(Source: SBP Islamic Banking Bulletins, 2015–2023)

The information shows a gradual increasing trend in the value of the assets and percentage of the shares. The steep growth since 2020 follows policy favour and customer preference to Shariah-compliant banking. According to the researchers like Awan and Bukhari (2021), customer choice is centered around the ethical appeal and religious motives, and Ahmed (2020) observes that the macroeconomic factors and regulatory changes have strengthened the structural trust in the Islamic banking institutions.

Conversely the conventional banking assets still prevail in absolute terms partly due to the fact that they have been developed over decades in Pakistan, and they are more technologically developed. But the rate of conventional banks growth has been comparatively lower than the Islamic banks. This indicates that Islamic banking is relatively small but its long-term prospect is much higher because of its high growth and increase in demand.

Another measure of confidence of the population is deposit growth. Islamic banks have grown in number of deposits significantly, but they are still not as high as those in conventional banks. A comparison of deposits is made in the table below.

Table 2: Comparison of Deposits in Islamic vs. Conventional Banking (2023)

Banking Type	Deposits (PKR Trillion)	Market Share (%)
Islamic Banking	4.0	22.0%
Conventional Banking	14.2	78.0%

(Source: SBP Financial Stability Review, 2023)

The figures show that, Islamic banking holds around 22 percent of the total deposits yet conventional banks hold majority. This disparity is an indication of differences in networks of branches, customer reach, and service access. Khan and Bhatti (2019) emphasize that traditional banks enjoy a better technological application practice such as digital platforms, online banking and fintech integration. The areas where Islamic banks are doing better are at times falling behind because they have less to invest and must verify the financial technologies used by Shariah.

Branch expansion is another important key performance indicator. The growth of the branch network of Islamic banking was substantial, particularly since 2015, when SBP stimulated the spread of Islamic banking to the under-served regions. The rural and semi-urban regions have recorded increased needs of Shariah compliant financial products as a result of cultural and religious affiliation. The table below shows distribution of branches.

Table 3: Branch Network Comparison (2023)

Banking Type	Number of Branches	Share of Total Branches (%)
Islamic Banking	3,800	23%
Conventional Banking	12,600	77%

(Source: SBP Statistics Department, 2023)

Similar trends are also observed in the branch data: the Islamic banking organizations are growing steadily, although they still lag behind the traditional ones in the number of outreach. In other provinces, such as Khyber Pakhtunkhawa and Gilgit-Baltistan, the rate of the increase in the number of Islamic banking branches has been higher due to the great popularity of the Shariah-compliant products among the population.

Islamic banks do not finance themselves in the same pattern as conventional banks do. The Islamic banks focus on asset-backed modes which include Murabaha (cost-plus financing), Ijara (leasing), Diminishing Musharakah and Mudarabah. Murabaha is the mode that has been extensively used because it is less risky and similar to the traditional installment financing, although this makes Islamic finance less distinct, according to critics (El-Gamal, 2006). The Table below gives a summary of financing distribution.

Table 4: Islamic Banking Financing Modes (2023)

Financing Mode	Share of Total Islamic Financing (%)
Murabaha	39%
Diminishing Musharakah	28%
Ijara	15%
Mudarabah & Musharakah	6%
Others (Istisna, Salam)	12%

(Source: SBP Islamic Banking Bulletin, 2023)

The prevalence of Murabaha and the decline of Musharakah are indicative that the Islamic banks are interested in the lower risk and high demand products comparable to the conventional lending. This proves the hypothesis of Usmani (2018), who claims that Islamic banks, despite being Shariah-compliant,

may behave like traditional banks in economics due to the demands of the customers and the desire of the banks to be stable.

Comparing their profitability, the Islamic banks have been reporting rising returns but mostly at a lower level of profitability than the traditional banks. Profitability ratios like Return on Assets (ROA), Return on Equity (ROE) show that the conventional banks have scale advantages, technological advantage, and diversified investments. It has been established by Iqbal and Llewellyn (2020) that traditional banks tend to win over the Islamic ones in measures of efficiency because of their less complex organizational frameworks and availability of interest-based liquidity resources.

One of the issues that the data points out is the problem of liquidity management. The Islamic banks cannot use interest based instruments that the normal banks use like treasury bills (T-bills). Even though Pakistan has come up with Shariah compliant alternatives like government Sukuk, the amount and supply of such instruments are still inadequate. According to researchers such as Iqbal and Mirakhor (2017), the shortage of diversified liquidity instruments limits operational freedom and adds costs to funds of Islamic banks. According to SBP (2023), Islamic banks are more prone to liquidity ratios volatility than normal banks, particularly in times of economic uncertainties.

Shariah rule seems to be another significant theme in the information. The Islamic banks in Pakistan must have Shariah Boards and internal Shariah audit systems. Although this builds credibility, it also adds to the costs of operation and complexity of the procedures. According to Khan and Bhatti (2019), no qualified Shariah scholars are available who may possess both financial and religious knowledge. The SBP (2023) data has verified that variation in interpretation by Shariah boards in various banks leads to product variation hence impacting standardization.

There is interesting data of customer perception. Although the motivational drivers of the decision to select Islamic banking are mostly driven by religion (Hanif, 2018), other aspects like the quality of the services offered, technological effectiveness, the presence of ATMs, mobile banking, and employee attitude have a strong impact on satisfaction. Islamic banking is usually seen as more ethical by the customers but with slower processes occasionally because of the Shariah checks. According to Awan and Bukhari (2021), there are customers who revert to traditional banks because of delays in financing decisions, or suspected lack of flexibility in product designs.

The government policy is also identified by the data. The long-term goal of Pakistan to turn the banking system into a completely Islamic model is publicly committed by the country and in 2022, the Federal Shariat Court stated that by the deadline, the country must turn an interest-based operation into none whatsoever. This political endorsement is encouraging to Islamic banking, but analysts like Ahmed (2020) caution that such practical work will entail the massive structural changes of the banking and regulative institutions.

On the comparative dimension, the information indicates that conventional banking continues to be leading in regards to the total size, the technological penetration, the coverage of the customers, and the profitability. Nevertheless, Islamic banking is superior in terms of yearly growth rates, customer confidence, and adherence to religious beliefs. In economic recessions, Islamic banks have been relatively resilient owing to their nature as asset backed investments (Hasan & Dridi, 2011) but have an issue with liquidity crunch and poor product innovation.

Altogether, the results show that Islamic banking in Pakistan has achieved a significant development and has a great potential of improvement in the future. Nevertheless, it still has the problem of liquidity management, product diversification, outreach of branches, adoption of technologies, standardization, and human resource problems. Conversely, the traditional banking system is better established but with slower growth and low trust among the religiously oriented customers. The comparative analysis reveals that Islamic banking is booming fast but attaining full competitiveness will involve strategic changes and also by increasing Shariah-compliant financial instruments and also investing more in technology and human capital.

CONCLUSION AND RECOMMENDATIONS

The discussion of the history and problems of Islamic banking in Pakistan shows that the financial sector has been developing dynamically and changing, but has achieved impressive results during the last 20 years. The Islamic banking has ceased to be a marginal branch of the financial system and it has captured more than 20 percent of the entire banking market share (SBP, 2023). This fast growth is an indicator of growing confidence among the people, high demand of Shariah compliant products and continuing regulatory goodwill. According to the literature and data, Islamic banking has become credible because of its ethical background, the ban on the charge of interests (riba), and the idea of asset guarantees that foster fairness and risk-sharing (Chapra, 2016; Usmani, 2018). Meanwhile, traditional banking still remains bigger, more stable, more advanced in technology, and more profitable and represents decades of institutionalization and development of infrastructure.

The results indicate that Islamic banking is better than conventional banking in terms of annual growth rates and customer trust grounded on religious values; however Islamic banking has structural weaknesses that act as an obstacle towards complete competitiveness. Overall, the major issues are a lack of Shariah-compliant liquidity management instruments, the prevalence of the uses of debt financing products like Murabaha, the absence of qualified Shariah scholars, inefficiency, slower rates of technological adoption, and the inconsistency of Shariah governance in institutions (Khan and Bhatti, 2019; Ayub, 2019; Iqbal and Mirakhor, 2017). Moreover, similarity of certain Islamic products with the conventional products has generated the issue of authenticity of Islamic finance practices (El-Gamal, 2006). Nevertheless, there are still these restrictions, and it can be seen that the government efforts, including SBP reforms and the decision of the Federal Shariat Court to abolish interest-based systems, can result in substantial prospects of the future development.

The analysis of the Islamic and conventional banking points out to a dual-sided financial landscape, with the Islamic banking growing at an impressive rate, yet still in its infancy, and with the conventional banking being structurally ahead, but slower in growth rates. Islamic banking has its strong sides in its ethical attractiveness, ability to endure financial crises and increasing market demand whereas conventional banking is strong in terms of technology, capital base, branch outlets and operational efficiency. Reform and strategic interventions in the Islamic banking are required to make Islamic banking fully competitive.

Following the findings, the recommendations given below are suggested to boost Islamic banking in Pakistan and make it more competitive with conventional banking.

To begin with, it is necessary to increase and diversify Shariah-compliant liquidity management tools. The Islamic banks are at present limited by low supply of Sukuk and other short term instruments. SBP needs to increase the rate of Sukuk issues, more short-term funds and should collude with other international Islamic finance institutions in creating innovative instruments. Increased liquidity facilities will minimize the financial risk and better resilience during economic stress.

Second, Islamic banks must focus on the development of products. The extreme use of Murabaha and other debt-like instruments lowers the uniqueness of the Islamic finance. The banks need to consider equity-based instruments like Musharakah and Mudarabah to be aligned to the actual spirit of the Islamic economics (Iqbal and Mirakhor, 2017). The development of diversified products that meet the requirements of the current consumers can be promoted by encouraging research and development units in Islamic banks.

Third, we need to enhance the Shariah governance. The limited number of qualified Shariah scholars and divergence between rulings pose a problem to standardization. It can be encouraged to establish a centralized Shariah Supervisory Board on a national level, like the one in Malaysia, which can bring about conformity, minimize ambiguity, and increase the confidence of the customers. The modern finance as well as the Islamic jurisprudence should also be undertaken through continuous training of bankers to enhance the human resource capabilities.

Fourth, the Islamic banks need to spend a lot of money in technology. The reason why conventional banks have a substantial advantage is because of highly advanced digital banking, mobile tools, artificial intelligence tools, and online customer platforms (Khan and Bhatti, 2019). Fintech solutions should be used by Islamic banks to streamline their operations and digitize them, which will enhance accessibility, efficiency, and customer satisfaction. The growth of digital banking is important in accessing younger and technologically advanced clients.

Fifth, awareness campaigns should be conducted to remove the negative perception about Islamic banking. A lot of customers still do not know how Islamic financial products should operate or why some pricing schemes seem to be like in the traditional banking (Farooq & Zaheer, 2020). Banks ought to invest on financial literacy programs, community seminars and clear marketing strategies which explain in a clear manner the Shariah principles, product mechanisms and benefits to the customers.

Sixth, the policy makers should consider long term regulatory assistance to facilitate the shift toward a dual banking model to a more combined Islamic financial system. The initiative of the government to shift into interest-free economy involves a concerted action of reforms, which are fiscal policy, management of government debt, taxation, and legal provisions. The policymakers are advised to engage the Shariah, economists and banking professionals in formulating holistic reforms aimed at facilitating a working implementation.

Lastly, Islamic and conventional banks should be encouraged to work together. Islamic banks can implement best practices without losing Shariah integrity through sharing technological platforms, co-financing schemes and knowledge exchange schemes. This kind of cooperation may speed up the development of the industry and enhance the overall financial stability.

To sum up, Islamic banking in Pakistan is moving in a good direction with the increased customer demand, ethical principles, and government support. Nevertheless, in order to realize its full potential and compete favorably with the traditional banking, Islamic banks need to deal with structural issues by diversifying their products, improving technology, better Shariah governance, augmenting liquidity instruments, and raising public awareness. Through a long-term reform and strategic growth, Islamic banking is set to become a revolutionary aspect of the future of the Pakistani finance system and make a significant contribution to a more inclusive, ethical and stronger economic system.

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