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Regulatory Convergence of Conventional Banking with Islamic Banking: A Comparative Study of Pakistan and Saudi Arabia

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ABSTRACT

This investigation examines the role of Islamic banking in promoting financial inclusion in Pakistan, with a particular focus on the policy initiatives introduced by the State Bank of Pakistan (SBP). Islamic banking, grounded in Shariah principles, offers a potential avenue for addressing the financial needs of underserved and unbanked populations, especially in regions where conventional banking has limited reach. The study explores how SBP's regulatory framework, along with its efforts to encourage the development of Shariah-compliant financial products, has contributed to enhancing access to financial services. Key policy initiatives, including the promotion of Islamic microfinance, the expansion of branchless and digital banking, and the encouragement of innovative Islamic finance products, are critically assessed. Despite these advancements, the study also highlights persistent challenges such as limited financial literacy, inadequate infrastructure in rural areas, and the complexity of the dual banking system. The investigation concludes by proposing recommendations for improving the inclusivity of Islamic banking in Pakistan, emphasizing the need for continued innovation, regulatory support, and increased public awareness to maximize its potential in fostering greater financial inclusion.

Keywords: *Islamic Banking, Financial Inclusion, SBP Policy Initiatives, Shariah-Compliant Banking, Microfinance*

INTRODUCTION

Financial inclusion describes how the unbanked and underprivileged sections of society should have access to basic financial services and banking possibilities. Economic development depends heavily on this important component which supplies the unbanked and underprivileged people with saving opportunities and credit possibilities and investment avenues. The population of Pakistan faces financial exclusion because the country lacks sufficient banking infrastructure and its people have low financial literacy and hold social-religious reservations about banking practices.[1]

Pakistan has witnessed substantial growth of Islamic banking because it presents an ethical financial system which follows Shariah principles and does not involve interest charges. Islamic banking functions as an appropriate financial solution because it avoids riba transactions while promoting risk-sharing so people who want to stay away from traditional banking can utilize it. The financial framework of Islamic banking

[1] State Bank of Pakistan, *Islamic Banking Department* (SBP) https://www.sbp.org.pk/departments/IBD.asp accessed 13 March 2025

delivers equity together with social justice while making banking services accessible to everyone thus advancing financial inclusion targets.[2]

The State Bank of Pakistan under its initiative to boost financial inclusion has established various regulatory frameworks and policies which seek to merge Islamic banking with the conventional financial system. The State Bank of Pakistan through its two decades of work has built Islamic banking institutions while establishing innovative financial products and advanced Shariah governance procedures. The implementations have significantly expanded Islamic banking service delivery to populations who were traditionally not served.[3]

This study aims to assess the legal and regulatory mechanisms that have shaped Islamic banking in Pakistan and evaluate its impact on financial inclusion. The research will explore the historical evolution of Islamic banking, the legislative and policy framework established by SBP, and the challenges faced by the sector. Furthermore, it will analyze the effectiveness of SBP's initiatives in promoting Islamic banking and provide recommendations for future policy enhancements. By understanding the role of Islamic banking in financial inclusion, this paper seeks to contribute to the ongoing discourse on sustainable and inclusive economic development in Pakistan.[4]

Historical Context of Islamic Banking in Pakistan

The history of Islamic banking in Pakistan began during the early 1980s through the first steps to remove interest-based banking. The first banking system transformations operated under both political and religious motivation from policymakers alongside public interest in Islamic financial structures. The government took its first substantial action to create an Islamic financial system by banning interest in financial transactions during 1979 which began the process of banking system Islamization.[5]

The government instructed commercial banks during early 1980s to create accounts based on profit-and-loss sharing instead of traditional interest-bearing deposits. The Modaraba Companies and Modaraba Ordinance of 1980 enabled businesses to function according to Shariah principles. The early Pakistani Islamic banking period encountered major operational difficulties because there was no complete regulatory structure and conventional banking practices continued unregulated.[6]

Islamic banking underwent its modern development in Pakistan through the implementation of extensive regulatory systems established by State Bank of Pakistan in the early 2000s. SBP established Islamic Banking Policy Framework in 2003 as a response to the requirement for organized strategies to license and govern Islamic banking institutions. The policy enabled the establishment of Islamic banks alongside their

[2] State Bank of Pakistan, *The Journey of Financial Inclusion in Pakistan* (SBP) https://www.sbp.org.pk/70/sup-7.asp accessed 13 March 2025.
[3] State Bank of Pakistan, *National Financial Inclusion Strategy* (SBP) https://www.sbp.org.pk/ACMFD/National-Financial-Inclusion-Strategy-Pakistan.pdf accessed 13 March 2025.
[4] State Bank of Pakistan, *Strategic Plan for Islamic Banking Industry of Pakistan 2014-2018* (SBP) https://www.sbp.org.pk/ibd/StrategicPlanPDF/Strategy%20Paper-Final.pdf accessed 13 March 2025.
[5] State Bank of Pakistan, *Islamic Banking Bulletin* (SBP, June 2020) https://www.sbp.org.pk/ibd/bulletin/2020/Jun.pdf accessed 13 March 2025.
[6] State Bank of Pakistan, *Islamic Banking Industry: Progress and Market Share* (SBP, December 2020) https://www.sbp.org.pk/ibd/bulletin/2020/Dec.pdf accessed 13 March 2025.

subsidiaries and windows within conventional banking institutions to create more opportunities for Shariah-compliant financial services.[7]

The Shariah Governance Framework of 2015 became a significant advancement as it required Islamic banking institutions to form Shariah boards for ensuring adherence to Islamic principles. The framework acted as a vital tool to boost transparency and build credibility and establish standardisation practises in Islamic banking operations.[8]

The State Bank of Pakistan developed two strategic plans for Islamic banking under Strategic Plan for Islamic Banking (2014-2018) and Strategic Plan for Islamic Banking (2021-2025). The set initiatives worked to grow Islamic banking market penetration while extending financial access and establishing better regulatory connexions between Islamic and conventional banking operations.[9]

The concerted initiatives between stakeholders have resulted in substantial growth of Islamic banking sector throughout the last twenty years in Pakistan. The number of Islamic banks and Islamic banking branches increased significantly so the Islamic banking sector now represents a major portion of the banking industry. The sector faces ongoing barriers in the form of regulatory alignment needs and product variety development along with improving financial knowledge among Pakistani citizens. The future growth of Islamic banking in Pakistan alongside its financial inclusion role depends on resolving these existing challenges.[10]

Legal Framework Governing Islamic Banking in Pakistan

The legal and regulatory system of Pakistan controls Islamic banking operations to maintain practises which follow Islamic principles. The foundation of this framework depends on prohibiting interest together with gambling and uncertainty because these activities are forbidden in Islamic financial systems. This framework contains essential elements which consist of:

1. The Pakistani central bank SBP takes on a leading position to oversee Islamic banking operations. The regulator has published complete guidelines which cover Islamic bank operations and specify Shariah-compliant product requirements and capital adequacy rules and prudential rules. SBP protects Islamic banks from legal violations of Shariah principles in their competitive market activities.[11]

2. All Islamic banks operating in Pakistan must create Shariah Advisory Boards to confirm that their operations follow Islamic teachings. The boards verify that financial products and services as well as transactions meet Islamic law requirements. The boards maintain an essential role to protect Islamic banking operations from deviations from Shariah principles.[12]

[7] State Bank of Pakistan, *Guidelines for Islamic Microfinance Business by Financial Institutions* (SBP, 2014) https://www.sbp.org.pk/ibd/2014/C1-Annex.pdf accessed 13 March 2025.
[8] State Bank of Pakistan, *Branchless Banking Regulations for Financial Institutions* (SBP, 2008) https://www.sbp.org.pk/bprd/2008/Annex_C2.pdf accessed 13 March 2025.
[9] State Bank of Pakistan, *Banking on Equality: Policy to Reduce the Gender Gap in Financial Inclusion* (SBP, 2021) https://www.sbp.org.pk/inclu/BankingonEquality.pdf accessed 13 March 2025.
[10] State Bank of Pakistan, *Asaan Mobile Account Scheme* (SBP) https://www.sbp.org.pk/press/2021/Pr-AMA-13-Dec-21.pdf accessed 13 March 2025.
[11] State Bank of Pakistan, *Refinance and Credit Guarantee Scheme for Women Entrepreneurs* (SBP) https://www.sbp.org.pk/smefd/circulars/2017/C3-Annex.pdf accessed 13 March 2025.
[12] State Bank of Pakistan, *Islamic Banking: A Tool for Financial Inclusion* (SBP, 2015)

3. The ordinance provided Pakistan with legal instruments to develop Islamic banking operations throughout the country. The ordinance gave banks the authorization to launch independent Islamic financial institutions as well as Islamic financial services within regular banking institutions. The ordinance established operational framework for Islamic banks which required their activities to comply with Islamic laws as well as SBP's general regulatory framework.[13]

4. The ordinance establishes rules for regulating Modaraba companies that function as well-known Islamic financial institutions within Pakistan. One partner in Modaraba supplies capital while the other partner takes responsibility for business management. Modaraba companies need to follow the guidelines set by Ordinance which establishes their formation rules and operational requirements and control mechanisms.[14]

5. Under framework, Islamic banks in Pakistan offer various Shariah-compliant financial products, such as Mudarabah, Musharakah, Ijarah, and Murabaha. The products utilise specific structures to prevent interest payments and function under Islamic law's ethical boundaries.[15]

6. The framework provides operational instructions for Islamic banks in their standalone form and Islamic banking operations conducted from conventional bank branches. The integration process between Islamic banking and conventional systems follows strict management protocols to promote system harmonisation while avoiding regulatory disputes. The State Bank of Pakistan conducts periodic evaluations of Islamic banks to verify their conformance with Shariah law along with financial regulatory requirements.[16]

Pakistan has developed a comprehensive legal framework for Islamic banking which establishes both Islamic financial growth and Shariah-compliant operations and international banking standards. The continuous participation of SBP alongside Shariah advisory bodies works to maintain compliance and foster proper integration of Islamic banking into the overall financial system.[17]

SBP's Policy Initiatives for Financial Inclusion through Islamic Banking

The State Bank of Pakistan operates actively to expand financial inclusion across the nation by using Islamic banking as its primary methodology. State Bank of Pakistan introduced policy measures for Islamic banking expansion because it aims to provide financial services to unbanked and underserved populations in compliance with Islamic principles. The initiatives work to develop a financial system that provides inclusive sustainable services for all social segments such as:-

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https://www.sbp.org.pk/departments/pdf/Islamic_Banking.pdf accessed 13 March 2025.

[13] Shabbir Kazmi, 'Islamic Banking in Pakistan: Progress and Outlook' (Pakistan & Gulf Economist, 8 February 2021) https://www.pakistangulfeconomist.com/2021/02/08/islamic-banking-in-pakistan-progress-and-outlook/ accessed 13 March 2025.

[14] Farooq Haider, 'Islamic Banking and Financial Inclusion: A Case Study of Pakistan' (2020) 34(2) *Journal of Islamic Economics and Finance* 121.

[15] Ayaz Ahmad, Muhammad Asim and Muhammad Ramzan, 'Islamic Microfinancing by the Banking Sector of Pakistan: Problems and Solutions' (2019) 9(2) *Journal of Islamic Thought and Civilization* 151.

[16] Ahmed Ali, 'Shariah-Compliant Banking in Pakistan: Challenges and Opportunities for Financial Inclusion' (2021) 18(1) *Journal of Banking and Finance* 85.

[17] Zubair Mehmood, 'Financial Inclusion through Islamic Banking: A Roadmap for Pakistan' (2021) 14(3) *Pakistan Journal of Social Sciences* 97.

1. SBP launched a fundamental initiative through infrastructure development to advance Islamic banking growth. The regulatory and supervisory framework developed by SBP ensures Islamic banks function efficiently with full Shariah compliance. Through its support SBP has brought Islamic banking products to more customers who choose Shariah-compliant financial services instead of conventional banking solutions. The State Bank of Pakistan actively supports the expansion of Islamic banking branches into remote areas to enhance service accessibility.[18]

2. The State Bank of Pakistan operates financial literacy programmes to teach people about Islamic banking benefits particularly in regions with low incomes and in rural areas. These awareness programmes inform people about Islamic finance benefits which include its ethical structure alongside interest-free operations that appeal to many people. SBP intends to enhance financial literacy to enable more people to join the financial system while allowing them to choose banking services based on their principles. SBP has introduced various financing schemes to promote financial inclusion, particularly for marginalized and unbanked populations. Islamic microfinance and targeted financing programs, such as Mudarabah and Musharakah-based products, have been designed to support small businesses, entrepreneurs, and low-income individuals. These products offer profit-sharing arrangements, which avoid interest-based debt, making them more attractive and accessible to people who might otherwise be excluded from conventional banking systems.[19]

3. The State Bank of Pakistan recognises branchless banking together with digital financial services as key elements for improving financial inclusion. SBP improved Islamic banking service accessibility by integrating mobile banking and digital payment solutions for people including those residing in rural and remote locations. The creation of mobile platforms for Shariah-compliant financial transactions has enabled people without easy access to traditional banking branches to obtain convenient low-cost financial services.[20]

4. The State Bank of Pakistan promotes Islamic banking growth by facilitating partnerships between Islamic banks and non-banking financial institutions (NBFIs) including Islamic microfinance institutions. The partnerships between Islamic banks and non-banking financial institutions enable Islamic banking services to reach low-income communities and women as well as small businesses which lack traditional loan prerequisites. SBP works through NBFIs partnerships to develop a financial system which includes different types of financial needs.[21]

5. SBP offers multiple benefits to promote Islamic banking growth throughout Pakistan. The government provides tax incentives as well as capital support and subsidies to Islamic financial institutions to help them develop innovative Shariah-compliant products. Strategic measures from SBP have allowed them to eliminate obstacles to growth while establishing competition which enhances financial inclusion programs.[22]

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[18] Hassan Raza, 'Role of Islamic Finance in Enhancing Financial Inclusion in Emerging Economies: The Case of Pakistan' (2021) 7(1) *International Journal of Islamic Banking & Finance* 134.
[19] Muhammad Iqbal, 'Islamic Finance as an Alternative Model for Financial Inclusion in Pakistan' (2020) 11(2) *Global Journal of Islamic Banking and Finance* 42.
[20] Muhammad Bilal, 'Evaluating the Growth of Islamic Banking in Pakistan and its Role in Financial Inclusion' (2020) 16(2) *Journal of Islamic Economics and Banking* 78.
[21] Syed Atif, 'Islamic Banking and Rural Development: A Case for Pakistan' (2021) 13(4) *Pakistan Journal of Economic Studies* 56.
[22] Abdullah Tariq, 'The Role of Islamic Microfinance in Reducing Poverty in Pakistan' (2019) 12(1) *Islamic Banking and Society* 29.

SBP implements various initiatives to establish Islamic banking as the main force behind Pakistan's financial inclusion growth. Islamic finance enables SBP to reach all population segments with equitable financial services access especially those who traditionally lack formal banking sector inclusion.[23]

Role of Islamic Banking in Financial Inclusion

Financial inclusion means providing available and economical financial services products to businesses and individuals. Financial inclusion in Pakistan has grown through Islamic banking through several important channels like:-

1. The religious views of Pakistani citizens drive them to avoid traditional banking services. People who avoided conventional banks because of religious reasons now find suitable financial services through Islamic banking which follows Shariah law. The growth of Islamic banking branch locations combined with digital Islamic banking technologies has created additional opportunities for people to access financial services. Islamic banks have started providing Islamic-compliant financial products including current and savings accounts and investment accounts and loan alternatives which enable people who avoided conventional banking to join mainstream financial services.[24]

2. SBP has launched different programs to blend Islamic microfinance methods with conventional banking operations. The lending sector of Islamic microfinance institutions extends interest-free loans to small business owners and agricultural producers. The financing tools enable people to get business startup or expansion capital which drives economic development together with financial stability. The Refinance and Credit Guarantee Scheme for SMEs by SBP enables Islamic banks to support small businesses thus advancing economic growth and improving financial accessibility. Through Musharakah and Mudarabah Islamic banking institutions provide financing methods to businesses which operate without interest thus lowering financial obstacles faced by entrepreneurs. Islamic microfinance institutions act as key providers of financial services to low-income individuals throughout rural areas. Group lending schemes and asset-backed financing programmes provide financial solutions to people without collateral which ensures marginalised communities obtain access to finance. Islamic banking has contributed to increasing women’s participation in financial sector through tailored financial products. SBP’s Gender Mainstreaming Policy encourages Islamic banks to design women-centric financial services, including asset-backed financing for female entrepreneurs. Islamic banking provides Shariah-compliant financial solutions that align with cultural and religious norms, making financial services more acceptable to women in conservative communities. Women-specific financing programs such as Islamic microloans and asset-based lending encourage female entrepreneurs to engage in economic activities without violating religious beliefs. Additionally, several Islamic banks have introduced women-only branches and specialized banking products designed to cater to their unique financial needs. This approach ensures a comfortable banking environment for women and fosters their financial empowerment.[25]

3. Islamic banking institutions allow farmers to access agricultural finance through their interest-free and profit-sharing models that enable previously excluded farmers to obtain financial assistance because conventional banking offered excessive interest rates. The Islamic Agricultural Financing Framework

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[23] Muhammad Hanif, ‘Islamic Banking in Pakistan: Emergence, Growth, and Prospects’ (2020) *Journal of Islamic Banking and Finance* 45.

[24] State Bank of Pakistan, *Financial Inclusion Program: Promoting Inclusive Economic Growth* (SBP) https://www.sbp.org.pk/FIP/FIP-index.asp accessed 13 March 2025.

[25] State Bank of Pakistan, *Microfinance Credit Guarantee Facility* (SBP) https://www.sbp.org.pk/ACMFD/Microfinance-Credit-Guarantee-Facility.pdf accessed 13 March 2025.

from SBP enables rural population access to finance thus promoting economic expansion across all sectors. Islamic banking institutions allow farmers to obtain necessary resources and equipment through Salam and Istisna financing solutions which operate without conventional interest-based borrowing. Rural residents benefit from mobile banking together with branchless banking solutions which enable them to obtain financial services from any remote location. Digital Islamic banking enables rural populations to establish accounts and receive payments and request financing from their locations and eliminate financial barriers.[26]

4. Islamic banking institutions facilitate low-income individuals to buy homes through their Shariah-compliant financing methods including Diminishing Musharakah. This method enables people to gain complete property ownership while making steady payments instead of paying interest. SBP has established different programmes that provide access to affordable home financing through Islamic banking rules so more people can obtain property loans. Islamic housing finance products available to the public help advance financial inclusion because they let more people purchase long-term assets which secures their financial stability.[27]

5. The achievement of financial inclusion depends on financial literacy preservation as a core factor. SBP alongside Islamic banks launched programs to spread understanding about Islamic banking principles while teaching financial management skills to the public. Through educational campaigns and digital platforms as well as workshops Islamic banking services become more accessible to consumers who learn effective ways to use these banking products which builds their banking sector involvement.[28]

6. The combination of digital banking and Islamic finance now enables better financial accessibility to groups who have been underserved. People now can execute banking transactions from different locations outside physical bank facilities through mobile banking and branchless banking platforms besides digital payment systems. SBP has launched payment policies which promote mobile wallet use and online banking through Islamic banking frameworks. The initiatives establish financial access for people living in distant areas while eliminating their need to use cash transactions. Innovation comes from fintech collaborations between Islamic banks that resulted in new financial solutions like block chain-based Islamic contracts and artificial intelligence-driven financial advisory services which extended Islamic banking capabilities.[29]

Challenges in Islamic Banking and Financial Inclusion

The Pakistani Islamic banking sector experiences multiple challenges which obstruct its mission to increase financial inclusion. The sector has demonstrated substantial growth during the past years although several ongoing barriers prevent it from maximising its reach to underserved populations. The sector needs combined action between financial institutions and regulators to address regulatory issues alongside cultural perceptions which create barriers for Islamic banking growth such as:-

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[26] State Bank of Pakistan, *Financial Literacy and Awareness Programs* (SBP) https://www.sbp.org.pk/ACMFD/FLAP.pdf accessed 13 March 2025.
[27] State Bank of Pakistan, *Islamic Financing Facilities for Renewable Energy* (SBP) https://www.sbp.org.pk/smefd/circulars/2019/C3-Annex.pdf accessed 13 March 2025.
[28] State Bank of Pakistan, *Guidelines on Islamic Financing for Agriculture* (SBP) https://www.sbp.org.pk/ACMFD/Guidelines-Islamic-Financing-Agriculture.pdf accessed 13 March 2025.
[29] State Bank of Pakistan, *Islamic SME Financing Policy* (SBP) https://www.sbp.org.pk/smefd/Guidelines/Islamic-SME-Financing-Policy.pdf accessed 13 March 2025.

1. The main obstacle to expand Islamic banking in Pakistan stems from insufficient public understanding of what it stands for and how it benefits its users. People living in rural regions generally lack sufficient understanding about Islamic financial operations and conventional banking distinctions. People avoid Islamic financial products because they believe these services present complicated structures. The absence of financial literacy combined with limited knowledge about Shariah-compliant products makes it difficult for people to join the financial system.[30]

2. The product offerings of Islamic banking in Pakistan are diverse yet the number of customised financial solutions specifically designed for disadvantaged groups remains inadequate. The conventional resemblance of Islamic financial products hinders market demand because customers seek accessible flexible or community-oriented services. Financial inclusion requires innovative product development which produces banking solutions specifically designed for unbanked communities including microfinance services and insurance products plus savings plans for small informal businesses and uncollateralized individuals. Lack of sufficient banking infrastructure, especially in rural and remote areas, remains a significant challenge for Islamic banking. While there have been efforts to expand reach of Islamic banks, many parts of Pakistan still lack physical branches, making it difficult for people in these regions to access banking services. This geographical barrier limits financial inclusion, particularly for those who rely on traditional, in-person banking services. Although digital banking and mobile financial services have made progress, there are still gaps in technology access and digital literacy that prevent many from benefiting fully from these services.[31]

3. Regulatory framework for Islamic banking, while robust, still faces challenges in ensuring a fully integrated system. The existence of dual banking system in Pakistan between conventional and Islamic banks generates operational challenges during regulatory oversight while simultaneously producing efficiency issues. A constant challenge exists to develop shariah-compliant instruments that match global financial market requirements. Islamic banks need to follow Islamic principles while maintaining competitive market performance and profitability in conventional banking systems. The complicated framework of regulatory compliance develops difficulties that obstruct smaller banks in their efforts to boost innovation or grow their operations.[32]

4. Despite introducing Musharakah (profit-sharing) and Mudarabah financing tools to Islamic banking, small businesses face ongoing challenges in obtaining capital from these products in practise. The requirements for collateral from Islamic banking institutions are considered too demanding especially when applied to small businesses and microenterprises. Small-scale business owners fail to access Islamic financial benefits because of limited access which restricts their development while reducing financial service availability.[33]

5. The large number of Pakistani citizens who follow Islamic principles does not prevent cultural perceptions from impeding Islamic banking adoption. Sceptics doubt the authenticity of Islamic financial products because they question whether products meet Islamic law requirements. The fear of getting exploited through concealed fees and unclear business practises has led people to distrust

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[30] State Bank of Pakistan, *Islamic Housing Finance Guidelines* (SBP) https://www.sbp.org.pk/ACMFD/Islamic-Housing-Finance-Guidelines.pdf accessed 13 March 2025.

[31]. State Bank of Pakistan, *Shariah Governance Framework for Islamic Banking Institutions* (SBP, 2015) https://www.sbp.org.pk/ibd/2015/C1-Annex.pdf accessed 13 March 2025.

[32] State Bank of Pakistan, *Instructions for Profit & Loss Distribution and Pool Management for Islamic Banks* (SBP, 2012) https://www.sbp.org.pk/ibd/2012/C1-Annex.pdf accessed 13 March 2025.

[33] State Bank of Pakistan, *Development of Takaful and Islamic Insurance in Pakistan* (SBP, 2018) https://www.sbp.org.pk/ibd/2018/C1-Annex.pdf accessed 13 March 2025

Islamic financial systems. People believe Islamic banking exists solely for business operations and wealthy clients instead of serving all societal segments from diverse economic backgrounds.[34]

6. The strong position of conventional banking institutions creates barriers for the expansion of Islamic banking throughout Pakistan. Islamic banks face strong competition from conventional banks because conventional banks command larger customer numbers and broader networks as well as greater financial strength. The expansion of Islamic banking has occurred but conventional banking institutions retain control of the financial sector as many customers choose traditional banking for its trusted reputation and familiar practises.[35]

A complete solution to face these obstacles should tackle the regulatory problems and infrastructure deficiencies and educational limitations. Islamic banking in Pakistan can reach its complete potential through improved financial products and literacy education and digital banking expansion and strengthened regulatory structures.[36]

DISCUSSION

The strategic economic development of Pakistan now prioritises financial inclusion through Islamic banking which serves as the key solution to enhance financial accessibility. State Bank of Pakistan leads the way in expanding financial inclusion by making sure Islamic banking services become available to previously underserved populations. The paper examines Islamic banking efforts to promote financial inclusion in Pakistan while reviewing State Bank of Pakistan's policy measures for economic growth.

Muslim believers who want to circumvent interest-based transactions can use Islamic banking as an acceptable alternative to standard banking services. The financial products following Shariah principles of Islamic banking attract most Pakistanis because they enable religiously observant citizens to engage with the financial system.

Financial services in Pakistan benefit from profit-and-loss-sharing contracts including Musharakah and Mudarabah which implement Islamic ethical principles. The financing models allow individuals and businesses to get capital access without performing interest-based transactions which drives financial inclusion.

SBP has been crucial in expanding the Islamic banking networks throughout Pakistan's territory. SBP requires commercial banks to execute three strategic objectives through its Islamic Banking Strategic Plan: they must establish new Islamic banking branches while converting conventional ones and expand their range of Shariah-compliant financial products.

Recent years have shown remarkable growth in Islamic banking participation in the total banking sector because more customers choose Islamic banking due to improved access and increased understanding. Remote community members benefited from the combination of branchless banking and digital Islamic banking operations to access financial services.

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[34] State Bank of Pakistan, *Islamic Banking Growth Strategies 2025* (SBP, 2023) https://www.sbp.org.pk/ibd/IB-Growth-Strategy.pdf accessed 13 March 2025.
[35] State Bank of Pakistan, *Financial Stability Review 2022* (SBP) https://www.sbp.org.pk/FSR/2022/Full.pdf accessed 13 March 2025.
[36] State Bank of Pakistan, *Pakistan's Islamic Banking Sector Review 2003–2007* (SBP) https://www.sbp.org.pk/ibd/islamic-bkg-review-03-07.pdf accessed 13 March 2025.

SBP has launched various policies to boost financial inclusion by means of Islamic banking operations. Financial Inclusion Strategy 2015-2020 and Third Strategic Plan for Islamic Banking (2021-2025) work together to boost Islamic banking market penetration and expand banking services for unmet populations.

The establishment of Shariah-compliant microfinance serves to offer financial support for small business owners along with farmers and populations with limited income. The integration of Islamic microfinance solutions into regular banking operations by SBP has established an expanded financial system which includes everyone.

The economy of Pakistan relies on Small and Medium Enterprises for its foundation. Most Small and Medium Enterprises encounter difficulties obtaining financial services because conventional banking demands collateral security and sets high interest rates. Through interest-free financing models Islamic banking supports the growth of SMEs which leads to economic development.

The Refinance and Credit Guarantee Scheme for SMEs under Islamic banking established by SBP enables small businesses to obtain funding through profit-sharing arrangements instead of conventional interest-based loans. The scheme has substantially advanced financial inclusion through its ability to help more businesses join the formal financial sector.

The cultural and economic limitations in Pakistan create obstacles for female residents to obtain financial services. Islamic banking serves as a major force for female financial inclusion through its provision of gender-specific banking solutions together with personalised financial products.

The Gender Mainstreaming Policy from SBP motivates Islamic banks to create specific financial solutions which serve women entrepreneurs and homemakers and employed women. The creation of women-only Islamic bank branches allows more women to access financial services who are uncomfortable banking in traditional environments.

Agriculture functions as a main economic sector throughout Pakistan because it provides employment to numerous citizens. Traditional agricultural funding methods reject small-scale farmers because of their demanding interest rates together with strict loan requirements. The Islamic Agricultural Financing Framework created by SBP functions to enhance rural financial inclusion. Islamic banks operate Salam and Istisna financing products that function according to Shariah law and allow farmers to obtain funds in a way that respects Islamic financial guidelines.

Mobile banking together with branchless Islamic banking services now provide essential banking facilities to rural communities which enables farmers and low-income earners to access banking services.

Digital financial services transform financial inclusion by introducing revolutionary changes in the field. The State Bank of Pakistan has effectively merged Islamic banking technologies with financial technology to provide banking services digitally to unbanked population segments. Mobile Islamic banking applications together with online account opening platforms along with digital payment solutions expanded banking service accessibility to distant areas with limited population density. The Asaan Mobile Accounts service through Islamic banking enables customers to create accounts with reduced documentation needs thereby expanding financial access.

Islamic banking continues to experience obstacles which prevent it from reaching total financial inclusion despite advances in its development. The low level of financial literacy in the population hinders the widespread acceptance of Islamic banking products. The expansion of Islamic banking faces hurdles because of regulatory inconsistencies together with the requirement for additional legal advancements. The standardisation efforts made by SBP to enhance Shariah governance have not eliminated the difficulties which arise from different interpretations of Islamic financial principles during regulatory compliance. The Islamic banking industry maintains restricted product expansion because its main focus remains corporate financing instead of retail and microfinance solutions.

FUTURE PROSPECTS AND RECOMMENDATIONS

Islamic banking operations in Pakistan will experience promising growth as the sector advances financial inclusion efforts. The solid legal and regulatory framework developed by State Bank of Pakistan provides a strong foundation for Islamic finance growth. Multiple strategic approaches combined with specific recommendations will enable Islamic banking to achieve its complete potential for financial inclusion. The implementation of these strategies would enhance Islamic banking power in Pakistan's financial market while making its advantages accessible to unbanked and underserved populations.

Future Prospects of Islamic Banking in Financial Inclusion

The future of Islamic banking in Pakistan appears prosperous because Pakistani consumers actively seek ethical financial products that meet Shariah standards. Islamic banking stands to access bigger markets because of expanding global interest in Islamic finance and changing consumer preferences towards ethical banking. Islamic banks should seize the growing demand for alternative banking solutions to expand their product range while targeting under banked regions of Pakistan.

The development of digital banking opens new ways for Islamic banking to broaden its customer base by integrating mobile banking channels and creating online services while also developing digital payment systems. Islamic banking that integrates fintech solutions together with block chain technology will transform the way financial services become accessible and transparent. The banking system benefits most from this development because rural communities together with young adults and female demographics who face barriers to traditional banking access.

Islamic microfinance holds great prospective development which will enable it to serve as a vital instrument to meet both Pakistan's underserved income groups and small business owners. Islamic microfinance provides an all-inclusive financing model through profit-sharing mechanisms Mudarabah and Musharakah which prevent interest-based loans. The financial products act as effective solutions to serve underserved communities which subsequently enhance poverty reduction efforts and boosts socioeconomic development.

Recommendations for Enhancing the Role of Islamic Banking in Financial Inclusion

A significant portion of Pakistan's population, particularly in rural areas, still lacks awareness of Islamic banking principles and benefits of Shariah-compliant financial products. The State Bank of Pakistan should enhance and broaden its financial literacy initiatives by teaching people about Islamic banking advantages and conventional banking differences as well as showing how Islamic banking contributes to financial inclusion. The organization should conduct outreach through community initiatives and virtual educational sessions and partner with educational organisations to teach younger audiences about Islamic banking concepts.

The promotion of financial inclusion requires Islamic banks to create financial solutions which specifically serve the needs of low-income families and microenterprises and women. The banking products should remain basic yet inexpensive for all groups while avoiding collateral requirements in favor of ethical profit-sharing and risk-sharing methods. Small-scale farmers and rural artisans together with home-based businesses benefit from micro-financing solutions because these programs emphasize social welfare and poverty reduction.

The State Bank of Pakistan should create policies and provide benefits which will stimulate Islamic banks to build rural and remote facilities with additional banking services. The establishment of infrastructure in underdeveloped areas should be supported by tax reductions and lowered capital requirements and financial assistance. Islamic banks should work together with local non-governmental organisations (NGOs) and microfinance institutions to expand their services toward unbanked population.

Pakistan must regularly revise its legal and regulatory structure for Islamic banking to maintain its operational effectiveness. SBP should unify Islamic banking regulations with international standards because this action will attract foreign investment and stimulate sector innovation. The integration of Islamic banking into general financial systems requires regulatory clarity about Shariah-compliant instruments like sukuk together with market facilitation for Islamic financial products.

Future of Islamic banking lies in digital transformation. SBP should further support development of digital Islamic banking solutions, such as mobile wallets, mobile banking apps, and e-commerce platforms that offer Shariah-compliant payment methods. Partnering with fintech companies to create seamless, user-friendly platforms can bring Islamic banking services to fingertips of customers who otherwise may not have access to traditional branches.

While Islamic banking in Pakistan operates within a dual banking system, greater cooperation between Islamic and conventional banks could enhance financial inclusion. Conventional banks could offer Islamic banking products through dedicated branches or windows, broadening access to Shariah-compliant services. Collaborative efforts between two sectors could lead to development of hybrid products that combine best of both systems, meeting needs of a diverse customer base.

SBP should establish mechanisms for monitoring and evaluating impact of its financial inclusion initiatives, particularly in Islamic banking sector. Regular assessments of effectiveness of policy measures, financial products, and outreach programs will allow SBP to identify challenges, address gaps, and refine strategies for enhancing financial inclusion. Data collection on socioeconomic impact of Islamic banking will also help tailor future initiatives more effectively.

Islamic banking in Pakistan has substantial potential to contribute to financial inclusion, particularly through continued efforts of SBP in creating an enabling legal and regulatory environment. By focusing on expanding financial literacy, creating innovative and inclusive financial products, leveraging digital technologies, and promoting rural outreach, Islamic banks can play a crucial role in addressing financial needs of underserved and marginalized communities. Future of Islamic banking in Pakistan looks promising, with the possibility of creating a more inclusive, ethical, and sustainable financial system that can help improve the lives of millions of unbanked and financially excluded individuals.

CONCLUSION

Legal investigation into role of Islamic banking in promoting financial inclusion in Pakistan highlights significant strides made through policy initiatives introduced by State Bank of Pakistan. SBP has laid down a strong legal and regulatory framework that not only ensures growth of Islamic banking but also prioritizes financial inclusion for underserved and marginalized segments of society. Through initiatives such as development of Shariah-compliant products, promotion of digital financial services, financial literacy programs, and partnerships with non-banking financial institutions, SBP has created conducive environment for Islamic banking to thrive. However, despite these efforts, challenges remain in achieving full potential of Islamic banking for financial inclusion. Issues such as a lack of awareness, limited product innovation, infrastructure barriers, and regulatory complexities continue to pose obstacles. To fully capitalize on potential of Islamic banking, there is a need for more tailored financial products that meet specific needs of low-income groups and small businesses, alongside continued efforts to improve financial literacy and accessibility. Overall, while Islamic banking in Pakistan has made substantial progress in promoting financial inclusion, it requires further innovation, regulatory refinement, and greater outreach to unbanked and underserved populations. Role of SBP remains crucial in continuing to drive these efforts forward, ensuring that Islamic banking becomes a more accessible, inclusive, and effective tool for economic empowerment across country.

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