Islamic Banking Reform in Pakistan and the Transition to a Riba-Free System



Background and Context

The fundamental teaching of Islamic jurisprudence forbids riba (interest) because Islam views it as both ethically wrong and economically disadvantageous. Under Islamic economic principles, all financial operations should exclude riba while contributing to economic fairness, equitable resource allocation, and protective measures against exploitative banking methods. Today's worldwide financial structure bases its operations mainly on interest payments. The interest-based financial system maintains strong connections to extreme wealth concentration among elites, monopoly development, and worsening economic disparity between people.

Latest statistics show how one percent of global citizens posseses quantities of wealth surpassing those shared among the entire 99 percent of global residents. This systematic unfairness produces societal tension while promoting useless competitive behaviour. Islamic economists defend riba-free financial systems as practical ethical systems that can solve these structural economic issues[1]. This economic model eliminates interest and seeks to build inclusive prosperity while establishing a moral economic system for the country. The advancement of economic Islamisation in Pakistan began in the early 1950s when Shariah scholars started their advocacy, leading to the creation of the Islamic Economics Division at the State Bank of Pakistan. Foundational theoretical work happened during the first decades, yet substantial reforms started seriously in the late 1970s. The period implemented legal and institutional changes that worked toward establishing financial principles based on Islam. In 1991, the Federal Shariat Court declared bank interest payments prohibited by Islamic law. The Federal Shariat Court developed its previous order by issuing a complete ban on interest payments through its April 2022 judgment, with a five-year enforcement period. Following this judicial decision, Parliament passed the 26th Constitutional Amendment that sets January 1, 2028, as the deadline for riba elimination in Pakistan's financial system. Pakistan established a landmark legislative achievement through the 26th Constitutional Amendment, which reflects its continuous work to create a Shariah-compliant financial framework[1].

Islamic Banking Growth and Trend

The Islamic banking sector in Pakistan achieved significant growth during the fourth quarter of 2024, strengthening its place in Pakistan's national financial structure. Total assets at were PKR 11,070 billion in December 2024, which showed a significant rise of PKR 1,189 billion, which exceeded the PKR 10 trillion mark for the initial time. Similarly, deposits increased to PKR 7,905 billion after an increase of PKR 309 billion. Total assets inflated by 23.1 percent year over year, and deposits rose by 17.1 percent during the yearly comparison.



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Analyses of the financing portfolio revealed impressive results as it grew by 21.0 percent YoY to PKR 4,037 billion, followed closely by net investments expansion at PKR 4,987 billion, which increased by 17.7 percent from the preceding year. These financial developments indicate an increasing interest in Shariah-compliant financial operations, which will help to deepen financial inclusion inside the Islamic banking structure [2].

Table 1: Islamic Banking Sector Progress

(Amount in PKR Billion)

Particulars	Islamic Banking Industry Progress		Growth (YoY)	
	Dec-23	Dec-24	Dec- 23	Dec-24
Assets	8,994	11,070	24.4	23.1
Deposits	6,749	7,905	30.8	17.1
Investments (net)	4,235	4,987	38.8	17.7
Financing (net)	3,335	4,037	7.1	21.0
Number of Islamic Banking Institutions	22	22	—	—
Number of Branches	4,955	6,017	12.7	21.4
Number of Islamic Banking Windows	1,922	2,253	26.8	17.2

Source: Quarterly Islamic Banking Bulletin October-December 2024

Market Share, Number of Branches and Mode of Financing

Regarding market share, the total assets in Islamic banking operations represented 20.6 percent of the banking industry, while Islamic deposits comprised 24.9 percent of the market. Islamic banks provided 25.5 percent financing capacity to the total sector funds and maintained a 16.7 percent stake in all investments. The economic architecture demonstrates an escalating presence of Islamic financial services through these statistical indicators. Islamic Banking Branches (IBBs) increased to 6,017 physical locations yearly, representing a 21.4 percent yearly growth.

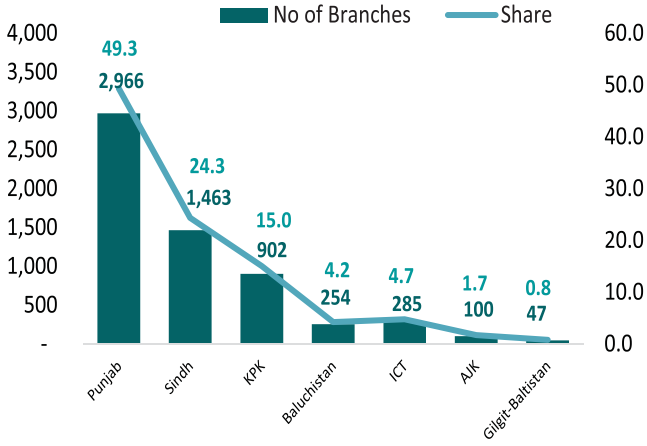
The number of Islamic Banking Windows (IBWs) increased substantially to 2,253 in a year and showed a 17.2% growth rate year over year. The rising demand for Shariah-compliant solutions led to this physical business expansion across the market[3].

Table 2: Market Share

Particulars	Share in Overall Banking Sector(%)	
	Dec-23	Dec-24
Assets	19.4	20.6
Deposits	23.2	24.9
Investments (net)	16.3	16.7
Financing (net)	27.4	25.5

Source: Quarterly Islamic Banking Bulletin October-December 2024

The Islamic Banking of Pakistan comprises six pure Islamic banks and sixteen traditional banks operating standalone Islamic Banking Branches (IBBs). During the last quarter of the year, the sector grew substantially in outreach through a 12.8 percent rise in its branch network expansion. The number of IBBs increased to 6,017 after 684 new branches were added throughout the last quarter of 2024. This expansion became possible when a major bank strategically converted all its conventional branch networks within Khyber Pakhtunkhwa and Balochistan provinces to Islamic banking branches, resulting in rapid sectoral physical expansion. IBBs preserve 132 districts as they expand their market penetration while continuing their efforts to promote financial inclusion. The total number of Islamic Banking Windows (IBWs) continued to grow during 2024 because they increased to 2,253 positions, which expanded Islamic banking service availability across Pakistan[2].

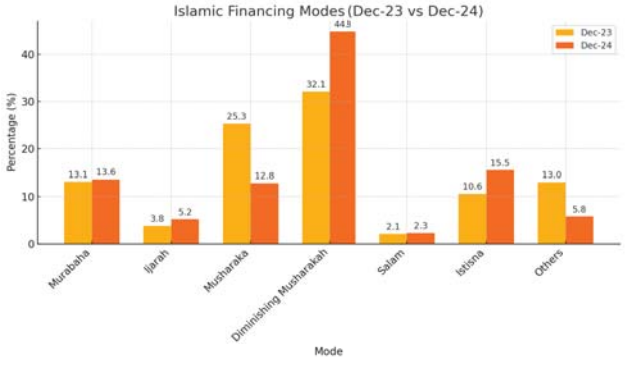


(Source: Quarterly Islamic Banking Bulletin October-December 2024)

Figure 1: Region Wise Branch Network

The research shows that Diminishing Musharakah is the principal financial instrument in a riba-free system, constituting 44.8% of the total financing pool. Istisna possesses 15.5% of the total financing share, and Musharakah takes up 12.8%. 26.9% of total financing encompasses various Shariah-compliant financing structures that Islamic Banking Institutions (IBIs) utilize strategically per their business fundamentals[2].

Figure 2: Mode Wise Financing (Share in %)



Source: Quarterly Islamic Banking Bulletin October-December 2024

Pakistan's riba-free financial system aims to learn from the experiences of Iran and Sudan and the financial systems in Malaysia and the GCC nations. The complete implementation of Islamic banking principles in Iran after the 1979 revolution provided ideological strength. However, economic isolation proved detrimental to innovation because of international sanctions and low integration with world economies. Sudan attempted a similar intervention in the 1980s but experienced political turmoil and poor state institutions, proving that proper institutional infrastructure and financial capabilities are essential for transition success.

The dual banking structure of Malaysia, consisting of conventional banking and Islamic banking, has brought a practical and enduring solution to the sector through strengthened regulations, financial awareness, and worldwide economic connections. The GCC countries, especially Saudi Arabia and the UAE, successfully enabled Islamic finance to work within global banking structures that remain Shariah compliant through implementing fintech and innovation to enhance competitiveness[3]. The diverse worldwide results demonstrate that Pakistan requires a multistage method to develop its riba-free finance system through legal improvements, institutional strengthening, and worldwide relations.

Pakistan's Riba-Free Future: A Bold Leap Toward Ethical Finance

The history of Islamic banking in Pakistan dates back several decades, yet the integration of this system into the national financial structure has seen rapid growth in recent years. A fully interest-free economy requires a financial transformation that is currently underway. Islamic finance operates through ethical investments, social responsibility, and risk-sharing models, which fundamentally differ from traditional banking practices. The system avoids speculative transactions and opposes excessive profiteering, establishing financial success by linking it to real economic value. Economic activities under such a system generate profits through shared-risk ventures and tangible achievements, rather than interest-based accumulation, naturally leading to an inclusive and meaningful economic structure. This approach aligns with Islamic doctrines while offering national security benefits for Pakistan.

Table 3: Global Experience

Country	System Type	Key Strengths	Main Challenges
Iran	Fully Islamic	Complete legal abolition of riba	Isolation, lack of innovation
Sudan	Fully Islamic	Broad-based use of Islamic contracts	Weak regulation and political instability
Malaysia	Dual banking model	Global leader in sukuk and Islamic fintech	Managing the balance between two systems
GCC States	Hybrid integration	Strong international standards and innovation	Conventional dominance in some areas

Given Pakistan's ongoing financial instabilities and exposure to external disruptions, it is crucial for the country to adopt a resilient and sound financial system. Islamic banks contribute to financial stability through their risk-assessment methods and transaction requirements based on asset ownership. Under the interest-free model, investments can be directed toward practical needs due to a favorable framework that channels funds into sectors such as agriculture, manufacturing, and social infrastructure. Through its operations, Islamic banking also reaches population segments that typically lack access to conventional banking institutions.

The upcoming years leading to 2028 will require full-scale improvements of financial instruments with concurrent reforms of banking regulations and fiscal policies. A well-planned execution of this transformation would achieve more than interest withdrawal from the economy by establishing a moral and accessible future for Pakistan's finance, which aims for sustained development [6].

Pakistan has established January 1, 2028, as its target date to remove Riba (interest-based finance) from its economic system. The national goal emanates directly from Clause (f) of Article 38 of the Constitution, establishing the "promotion of the social and economic well-being of the people." The amendment represents a decisive national transition toward establishing an economy based on Islamic principles focusing on equality and universal prosperity among all people[6]. Today, Pakistan's economy depends heavily on consumption and debt-based growth portfolios, which fail to comply with Islamic financial principles. The primary economic management component is interest-bearing loans, including domestic and international ones. The framework of a Shariah-compliant economy depends entirely on savings alongside equity-based investments, which share risks to the point that such a system cannot be created by passing laws. Pakistan needs to transform its borrowing behaviour into a society-wide practice of saving money to accomplish its economic transformation. The transition process proves difficult because Pakistani people hold weak confidence in financial institutions and display limited financial comprehension. Several policy-making adjustments, infrastructural developments, and behavioural transformations should work synchronously to achieve Pakistan's goal of a completely Islamic financial system because the current efforts appear aspirational instead of executable[7].

Key Challenges to Establishing a Riba-Free Economy in Pakistan

Pakistan funds its fiscal deficits through conventional interest-based instruments, including government bonds and treasury bills. Severe financial insecurity could emerge if the country attempts a swift disentanglement from its current dependency. Islamic financial institutions in Pakistan struggle to locate sufficient valid Shariah-compliant avenues to manage their liquidity and to make sovereign investments.[6] This imbalance reduces operational efficiency and diminishes the competitive advantage of these institutions.

The regulatory environments and supervisory procedures for Islamic and conventional banking systems reflect different interpretations. A lack of standardized Shariah governance leads to confusion among customers, eroding their trust in Islamic finance products. Contract enforcement within Islamic law shows inefficiency because of insufficient legal procedures, and judges lack experience with Shariah-compliant finance. As a result, the prolonged dispute-resolution process negatively affects institutional confidence. The total interest-bearing debt in Pakistan exceeds 75% of its national debt portfolio. Achieving an Islamic financial system through sukuk and mudarabah methods requires careful execution of multiple phases, legislative adjustments, and international cooperation. Professional expertise is a crucial deficit because it combines conventional financial systems with Islamic finance principles.

A shortage of professional expertise also presents a critical barrier, as the successful integration of Islamic finance demands knowledge of both conventional financial systems and Islamic principles. The limited number of Shariah scholars familiar with modern finance—and the lack of banking professionals trained in Islamic models—hinders innovation, standardization, and sustainable growth of the sector. Muslim nations, including Pakistan, find their interests restricted by their agreement with IMF and World Bank institutions and base their operations on interest-based frameworks, thus hindering complete departure from Riba[5]. The bond to conventional financial standards through debt responsibilities, credit assessments, and capital movements requires Pakistan to move forward with sensitivity while maintaining strategy [6].

Figure 3: Key Challenges to Riba-Free Transformation



Source: Author

Proposed RoadMap towards Riba-Free Financial system

Achieving a riba-free financial system in Pakistan requires a systematic, multi-phased approach to progress. The government should introduce Sukuk alongside conventional treasury bills and government bonds to ensure financial stability and gradually replace all interest-based instruments with Islamic financial alternatives. Developing innovative Shariah-compliant products, such as Islamic repo markets, is essential to address the shortage of liquidity management tools.

Implementing a standardized Shariah governance model is crucial to harmonize regulations and build customer trust. Enhancing the effectiveness of law enforcement through procedural reforms and introducing training programs to educate professionals in Islamic finance are also key steps. The use of hybrid debt instruments for public debt restructuring, coupled with partnerships with international stakeholders, can help mitigate risks associated with conventional financial systems.

The development and training of Islamic finance specialists depend on global collaboration to ensure the availability of qualified professionals. By advancing these efforts, Pakistan can successfully transition to a riba-free Islamic economy that supports both stability and sustained growth. The 2024–2028 strategic plan outlines a step-by-step framework to expand Islamic banking operations, reorganize financial systems, and convert existing banks to full Shariah compliance.

Table 4: Proposed Roadmap to Implementation: 2024–2028

Phase	Key Actions
Phase 1 (2024–2025)	Expand Islamic banking outreach; incentivize Islamic Sukuk over bonds.
Phase 2 (2025–2026)	Restructure government borrowing; introduce Islamic alternatives for savings accounts, pensions, and insurance.
Phase 3 (2026–2027)	Begin conversion of state-owned conventional banks; strengthen legal backing for riba elimination.
Phase 4 (2027–2028)	Complete transition for regulatory authorities; remove remaining interest-based financial instruments.

Source: Author

National savings must increase through motivational initiatives combined with education campaigns for the public, and enhanced transparency in Islamic banking, combined with the development of competitive Shariah-compliant investment options that adhere global financial standards to fulfill this vision. The target involves doing away with interest-based transactions while building an effective and universal financial system that serves all segments of society. The nation has less than three years until implementation, so the economic power of institutions will play a critical role in achieving this transformation. Pakistan can remove its interest-dependent transactions while meeting international financial operating standards. National willingness, combined with institutional backing and adequate execution, will allow Pakistan to lead other nations during their transition toward interest-free economic systems. Although accomplishing this goal will be difficult, it remains within reach when people make the right decisions.

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