Sharia'h practice at Islamic banks in Pakistan

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Received 26 March 2015
Revised 5 December 2015
14 June 2016
Accepted 1 May 2017

Abstract

Purpose – Islamic banks provide an alternative financial system based on *Sharia'h* (Islamic law). However, critics argue that operation at Islamic banks is violating *Sharia'h* particularly in terms of provision of interest free services, risk sharing and legal contract. The purpose of this paper is to empirically evaluate the *Sharia'h* practice at Islamic banks in Pakistan by considering some basic principles of *Sharia'h*.

Design/methodology/approach – Primary data are collected from 63 branches of Islamic banks in Pakistan. Questionnaire is used as an instrument. The study uses structural equation modeling that includes confirmatory factor analysis and regression analysis. Data are codified and analyzed using SPSS and Amos.

Findings – This study finds that Islamic banks are providing interest free services, ensuring that transactions and contracts offered by Islamic banks are legal and offering conflict-free environment to customers. In contrast, estimated results expose that Islamic banks are not sharing risk and *Sharia'h* supervisory board is not performing its role perfectly. Similarly, it is found that organization and distribution of zakat and qard-ul-hassan are weak at Islamic banks.

Research limitations/implications – Data are collected from Islamabad federal capital of Pakistan that hold just 5 per cent share of Islamic banking industry. This small share may not provide true picture of Islamic banking sector.

Practical implications – To ensure risk sharing, Islamic banking industry must consider the development of new modes of financing and innovation of more products based on *Sharia'h*. State Bank of Pakistan should ensure separate regulatory framework that enable Islamic banks to provide qard-ul-hassan, organize and allocate zakat.

Originality/value – This paper discusses the perception of bankers, who are actually the executors, about *Shariah's* practices at Islamic banks in Pakistan. There are not many discussions on this topic that could be found, and hence this could be considered as a significant contribution by this paper to the existing literature of Islamic finance.

Keywords Pakistan, Islamic banks, Structural equation modelling, Shariah practice

Paper type Research paper

1. Introduction

Financial institutions play crucial role in stabilizing economy by facilitating saving and financing business activities that generate more employment opportunities. Higher employment leads to higher income and better standard of living that contribute to economic growth. However, Stiglitz (2003) points out that global financial system has faced many crises since the past four decades because of various reasons such as mismanagement of risk, imprudent mortgage lending and inappropriate transparencies. This situation forced to consider an alternative financial system that ensures fairness and social wellbeing. As a result, Islamic financial system emerged (Sekreter, 2011). Islamic banks gained popularity in the wake of global financial crisis 2008, not only in Muslim countries but also in non-Muslim countries[1].

Unlike conventional banks, Islamic banks follow principles of *Sharia'h* that are derived from two primary resources "Quran and Sunnah" and two secondary resources Ijma

Journal of Islamic Accounting and Business Research
Vol. 9 No. 3, 2018
pp. 274-289

1759-0817
DOI 10.1108/JIABR-03-2015-0011

(consensus) and qiyas (logical reasoning; for details, see Table AI in Appendix). Thus, there is no space of ambiguous interpretation by the bankers according to their whims (Usmani, 2012).

In the literature, various theoretical studies explain the Islamic financial system by pointing out that Islamic banks follow *Sharia'h* (Islamic law). For instance, Khan (2011) describes that primary function of Islamic banks is provision of interest-free services. Chapra (2006) defines interest as an additional amount to actual amount that debtor pays to lender. Moreover, other *Sharia'h* scholars (Iqbal, 1997; Iqbal and Mirakhor, 2006; Iqbal and Tsubota, 2006) state that interest generally does not stand only for additional payment on loan but also includes any predetermined, fixed or additional rate of return that is guaranteed with considering the performance of investment.

Al-Jarhi (2004) states that Islam strictly prohibits all kind of interest for following reasons; first, earning without efforts do not contribute to economic growth rather it impedes the economic activity. Iqbal and Mirakhor (2006) describe that Islamic banks take money as a medium of exchange and store of value but do not consider it as a commodity. Therefore, the use of money cannot be charged. Second, interest exploits borrowers because fixed and predetermined amount is charged by lender irrespective of gain and loss to borrowers. In the case of loss, borrowers find it difficult to repay and interest increases on delay of repayment. It further increases the burden of borrower and consequently borrower gets poorer day by day. Third, interest destabilizes the financial system. For instance, liabilities of banks are absolutely guaranteed loans, but their assets face risks including risk of default. Consequently, banks cannot maintain position in the case of significant loss on asset side and therefore become unstable.

Moreover, Iqbal (1997) points out that prohibition of interest is the nucleus principle of *Sharia'h*. It does not represent the whole Islamic financial system; instead, it is supporter of risk sharing. Greuning and Iqbal (2008) report in their book "Risk-Sharing in Finance" that need of risk management is felt after the US financial disaster that influenced almost the entire world. To manage risk efficiently, various risk sharing instruments for instance "issuing government shares to finance development projects and restricting short sale and leveraging" are introduced. *Mudarabah* contract is the obvious example of risk sharing. *Mudarabah* is partnership between owner of capital and entrepreneur (user of capital) on profitloss sharing basis[2]. This contract not only increases funds in deposits but also enhances real economic activity by organizing funds in assets market.

While illustrating sharing of risk in Islamic finance, Sekreter (2011) highlights that depositors and lenders of conventional banks do not undertake any risk, the whole risk is born by bank and borrower. It contributes to accumulation of wealth in few hands. However, Islamic banks work on profit-loss sharing basis; thus, profit and risk is shared among the parties involved in financial contracts at predetermined ratio. Askari (2012) mentions that *Sharia'h* prohibits burdening debtor with entire risk of loan rather it encourages parties for mutual agreement to share production and marketing risks. Therefore, Islamic banks provide alternative options to financial institutions and savers who follow *Sharia'h*.

In addition, Wilson (1997) describes that Islamic financial institutions are offering valuable investment opportunities. Investment in an illegal and morally harmful business such as pork, alcohol, tobacco, weapons, gambling, cinema, music, porn and nude film making industry is prohibited. Anas (2009) describes that Islam forbids all kind of businesses that cause injustice and exploitation. Cowton (1994) explains that investment in Islamic banks consider the characteristics of potential investment along with expected risks and returns. Thus, Islam emphasizes on investments which must generate economic activity and ensure a morally healthy society that, in turn, contributes to economic development.

While describing Islamic financial system, Iqbal (1997) mentions that Islamic financial contracts and transactions are approved by *Sharia'h* supervisory board. This board scrutinizes the legality of contract and Islamic banks are obliged to undertake only approved contracts. Iqbal (1997) also emphasizes on sanctity (sacredness) of contract that minimizes the risk of asymmetry information and moral hazard. Usmani (2012) point outs that another distinguishable feature of Islamic banks is asset-backed financing. It represents that each Islamic financial contract is linked with tangible, original and identifiable assets. It ensures the creation of real assets and inventory.

Similarly, Farook (2007) states that corporate social responsibility is also important function of Islamic banks. It is extracted from central principle of Quran and Sunnah and says that Islamic banks are socially responsible to ensure access to finance and redistribution of wealth. To fulfill this responsibility, Islamic banks organize zakat, sadaqat and qard-ul-hassan (QH). These redistribution instruments approach each other to eliminate poverty and income inequality (Wahab and Rahman, 2011; Mohieldin *et al.*, 2012). Moreover, while investigating the possible application of QH in Pakistan, Saqib *et al.* (2015) find that QH is the need of poor farmers who prefer to avoid interest.

The above discussion suggests that by following *Sharia'h*, Islamic banks theoretically offer interest-free services, risk sharing, legal contracts, asset-backed financing, organize and distribute zakat, sadaqat and QH. However, some studies in the literature (Mills and Presley, 1999; Lewis, 2007; Chong and Liu, 2009; Hanif, 2011; Khan, 2011; Wilson, 2011; Zubair and Choudhry, 2014) criticize Islamic banks for violating the *Sharia'h*. For instance, Mills and Presley (1999) assert that products of Islamic banks such as *Murabahah* and *Ijara* are identical to conventional products. Similarly, Wilson (2011) claims that products offered by Islamic banks are not different from those of conventional banks. Another study by Chong and Liu (2009) points out that Islamic banks are operating similar to conventional banks, and only few Islamic banks are strictly working on profit-loss sharing in Malaysia.

Moreover, Lewis (2007) comments that although Islamic banking is predicted to provide an absolute interest-free financial system and to allocate resources by profit-loss sharing, in fact not providing such services. Khan (2011) unveils that features of Murabaha (Islamic financial contract) are conflicted with principles prescribed by *Sharia'h*. Similarly, Hanif (2011) reveals that practice of Islamic banking industry in Pakistan is not same as theory. The author points out that banking industry lacks human capital and foreign aid to ensure interest-free system. Furthermore, fraud, financial disruption and political instability impede actual operation at Islamic banks. Finally, Zubair and Choudhry (2014) expose that Islamic banks in Pakistan use illegal tricks and dodges and do not ensure interest-free banking. In fact, they deal in money and avoid trade.

However, Usmani (2012) explains that criticism on Islamic banking is unrealistic due to various reasons. For instance, share of Islamic banks in global financial sector is as small as a drop in the ocean. Usually, these banks are not offered support by central bank, legal and taxation system of their countries. Comprehensive regulatory framework for Islamic banking is still missing. Furthermore, being an emerging industry, Islamic banks lack human capital. These are obstacles in the way of running Islamic banks with true spirit.

In sum, the literature reveals globally apparent lack of empirical research pertaining to *Sharia'h* practice at Islamic banks. This motivates us to empirically investigate *Sharia'h* practice at Islamic banks in Pakistan. In this study, we collect survey data of 268 responses from employees of Islamic banks and use structural equation modeling to conduct empirical analysis.

1.1 Statement of the problem

The literature reveals that Islamic banks are criticized for violating *Sharia'h* in terms of interest-free services, risk sharing and legal investment by different authors in different countries. This indicates a gap between *Sharia'h* theory and practice of Islamic banks. This tempts us to evaluate *Sharia'h* practices at Islamic banks. As there are not many discussions on this topic, this study is a significant contribution to the existing literature on Islamic finance.

1.2 Research question

The above discussion suggests that studies in the literature criticize some important features of Islamic banks such as interest-free services, risk sharing and financial contracts. Our study aims to conduct an empirical analysis to scrutinize these features with the hypothesis that Islamic banks are not following *Sharia'h* in practice. In particular, we address the following research question.

RQ1. Do Islamic banks in Pakistan practice *Sharia'h* in its real essence while providing financial services or there are some differences in practice?

1.3 Significance of the study

Despite the mounting importance of Islamic banks in global phenomena, little empirical research is available on practice of Islamic banks. Leafing through literature, theoretical studies can be found regarding theory of emerging financial market. Hence, it is the judgment of the authors that no prior research is conducted to empirically estimate *Sharia'h* practice by Islamic banks in Pakistan. Furthermore, authors find that no pervious study has used an econometric model to assess the *Sharia'h* practice at Islamic banks. Thus, contribution of our study in the literature is threefold. First, it empirically analyzes *Sharia'h* practice at Islamic banks in Pakistan. Second, it uses the perception of bankers, who are actually the executors about *Sharia'h* practices at Islamic banks. Third, it develops a model by using theoretical literature to empirically investigate *Sharia'h* practice at Islamic banks.

The remainder of the study is organized as follows. Section 2 explains data and methodology. Section 3 provides empirical evidence. Finally, we conclude and recommend policy in Section 4.

2. Data and methodology

The data on practice of Islamic banks are unavailable. Therefore, we use a survey approach to assemble a comprehensive relevant data set. A sample of top ten Islamic banks that include 63 branches in Islamabad was selected. The data were collected by using questionnaire involving 27 survey items.

Questionnaire consists of three sections. First section asks information about demographic variables. Second section helps to gather information about interest-free services, risk sharing, legality of financial contract and so forth. Third section helps to learn whether Islamic banks are practicing *Sharia'h* and offering interest-free loan to poor in perceptions of bank staff. The detail of each item is given in Appendix Survey Items. (I have mentioned sections in table) Items consisted assessment of the perceptions of managers and employees of Islamic banks related to *Sharia'h* principles.

The questionnaire was designed following the literature on Islamic banking. For instance, survey items in section two ask about whether Islamic banks are based on Islamic teaching or principles, on the basis of previous various studies (Iqbal, 1997;

Iqbal and Mirakhor, 2006; Iqbal and Tsubota, 2006; khan, 2011) which emphasize that Islamic banks are based on *Sharia'h*. Similarly, another survey item extracted from Cowton (1994) and Anas (2009) investigates that whether Islamic banks are involved in investment of haram products. Following the survey items of Greuning and Iqbal (2008) and Askari (2012) in section three examines the risk sharing in Islamic banks. Moreover, some survey items related to redistribution channels like zakat and sadakat are derived from the theory of Farook (2007); Wahab and Rahman (2011) and Mohieldin *et al.* (2012).

Survey items were considered in such a way that enabled respondents to mention their level of agreement with the given statement. We use Likert scale, designed by Rensis Likert, to measure the different items of the questionnaire. It is a very popular rating scale for measuring ordinal data in social science research. This scale includes Likert items that are simply worded statements to which respondents can indicate their extent of agreement or disagreement on a five-point scale ranging from "strongly disagree" to "strongly agree". To ensure the validity of dimensions, the study conducted pilot survey using 30 observations. After obtaining and analyzing the results of pilot survey, a questionnaire format is revised and altered into a more suitable one. The data are compiled, coded and analyzed by using Statistical Package of Social Sciences (SPSS) version 16. The complete data set is available upon request.

The crux of our model is to estimate the *Sharia'h* practice at Islamic banks. To achieve the objective of research we focus on main features of Islamic banking: provision of interest-free services, risk sharing, legal contract, conflict-free relationship with customers, organization and distribution of zakat and QH. To address our research question, we use simultaneous equation modeling (SEM) that includes confirmatory factor analysis and multiple regression. Hoyle (1995) states that SEM explains the relationship among observed and latent variables. Former variables are measured directly and the latter cannot be measured directly rather these are measured with error. SEM is a methodology that tests the hypothesis to evaluate the theory related to some phenomena. Byrne (2010) provides three reasons to prefer SEM over multivariate techniques. First, unlike the multivariate techniques, it is not descriptive in nature; thus, it is most suitable to test the hypothesis. Second, it offers clear measurements of error variance parameters. Third, it incorporates both latent and observed variables, whereas other techniques depend only on observed variables.

Schumacker and Lomax (1996) state that SEM allows to make quantitative evaluation of model parameters and measures goodness of fit. It offers a wide variety of statistical tests of significance such as goodness of fit, chi-square and root mean square error of approximation. Moreover, SEM is a confirmatory rather than exploratory technique. It is frequently used by researcher to determine the validity of model. However, it does not help in finding a suitable model. Hoyle (1995) describes that SEM works well with large sample size generally 200-400 observations. Keeping the above evidence in mind, we find SEM more appropriate for analysis of this study, and we use Amos to conduct this analysis.

CFA is used to test whether the data fit the hypothesized measurement model. This hypothesized model is based on theory and previous analytical research. CFA involves five steps: model specification, model identification, model estimation, model evaluating and model modification. For SEM regression analysis, we used the following model specified under CFA with the help of literature, and the description is given in Table I:

$$\text{ShariaP}_i = \alpha_0 + \alpha_1 \text{ifree}_i + \alpha_2 \text{risksh}_i + \alpha_3 \text{legC}_i + \alpha_4 \text{Ncon}_i + \alpha_5 \text{SSB}_i + \alpha_6 \text{QH}_i + \alpha_7 \text{zakat}_i + \in_i$$

3. Empirical evidence

Our analysis is based on 268 respondents from the employees and managers of full-fledge Islamic banks (FFIB) and Islamic branches of conventional banks (IBCB) in Islamabad. It is observed that 64 per cent respondents are working in Full Fledge Islamic banks and 36 per cent respondents are working in IBCBs. Age of majority of the respondents is between 25 and 35 years. This suggests that most of the respondents are newly recruited and less experienced (Table II). To find the answer of research question, we follow CFA that involve the following steps.

3.1 Results of confirmatory factor analysis

The model specification and identification are the initial steps in confirmatory factor analysis. To conduct CFA, first, we specify a model with the help of literature. Various studies in the literature (such as Cowton, 1994; Wilson, 1997; Iqbal, 1997; Chapra, 2006; Iqbal and Mirakhor, 2006; Iqbal and Tsubota, 2006; Farook, 2007; Anas, 2009; Khan, 2011; Sekreter, 2011; Usmani, 2012 and Askari, 2012) describe that by following *Sharia'h* Islamic banks theoretically provide interest-free services, sharing risk legal financial contract. We

Variables	Notations	Description	Measurement scale
Latent	*Sharia'h*	Practice of *Sharia'h* by Islamic banks	1 = strongly disagree
Observed	ifree	Islamic banks offer provision of interest-free services	2 = disagree
	risksh	Islamic banks offer risk sharing	3 = neutral
	LegC	Islamic banks ensure legal contract and transactions	4 = agree
	SSB	*Sharia'h* supervisory board approve financial contracts	5 = strongly agree
	Ncon	Islamic banks have no conflict with investors or clients	
	QH	Islamic banks provide QH to poor	
	zakat	Islamic banks organize and distribute zakat	

Table I. Description of variables included in the model variables notations description measurement scale

Variables	Sample distribution	Frequency	(%)
Age of respondent	Under 25	81	30
	25 to 35	150	56
	35 to 45	28	10
	Over 45	7	3
	Total	266	99.3
	Missing	2	0.7
Education of respondent	Intermediate	2	0.7
	Under graduate	3	1.1
	Graduate	110	41
	Post graduate	123	45.9
	Other	14	5.9
	Total	252	94
	Missing	16	6
Linked with Islamic bank (IB)	Employee of IB	244	91
	manager of IB	24	9
	Total	268	100
Respondent from each bank	Full-fledge IB	171 97	64
	Islamic branch of IB		36
	Total	268	100

Table II. Sample profile of survey on *Sharia'h* practice at Islamic banks

are interested to scrutinize whether Islamic banks are practicing *Sharia'h*. Therefore, we specify the following model (Figure 1).

3.1.1 Model identification. This model includes three observed variables which are provision of interest-free services, risk sharing and legal contract and one latent variable *Sharia'h* practice. The observed variables are also the indicators of latent variable. This model has six parameters that include four variances (estimated for indicator error and error associated with latent variable), two factor loadings (interest-free and risk sharing, while the factor loading of legal contract has been set at one). To proceed for estimation in SEM, the model should be overidentified for example the difference between the number of parameters and number of elements in correlation matrix should be positive. Kline (2011) uses the following formula to calculate the number of elements in correlation matrix [p (p + 1)]/2. P represents number of observed variables. Thus, with three number of observes variable and six parameters, the degree of freedom of this model is zero. Therefore, this model is just identified. We cannot precede with this model in SEM. We need to re-specify our model.

3.1.2 Re-specification of the model. If we consider other studies to expand our model, we realize that some studies (such as Iqbal, 1997; Farook, 2007; Mohieldin *et al.*, 2012; Mirakhor, 2004; Mirakhor and Askari, 2010) also focus on the role of Sharia'h Supervisory Board (SSB). Indeed. Islamic banks offer only contracts and services approved by SSB. Moreover, Islamic banks are compelled to deny all wrong doings to avoid conflicts and to offer products approved by *Sharia'h* supervisory board. Moreover, Islamic banks are socially responsible to ensure access to finance and redistribution of wealth by organizing zakat and QH. Thus, by adding more variables of *Sharia'h* practice, we re-specify our model in the following form (Figure 2).

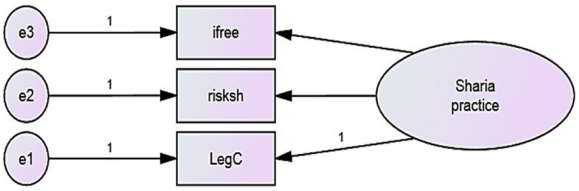

Figure 1.
Model to measure *Sharia'h* practice

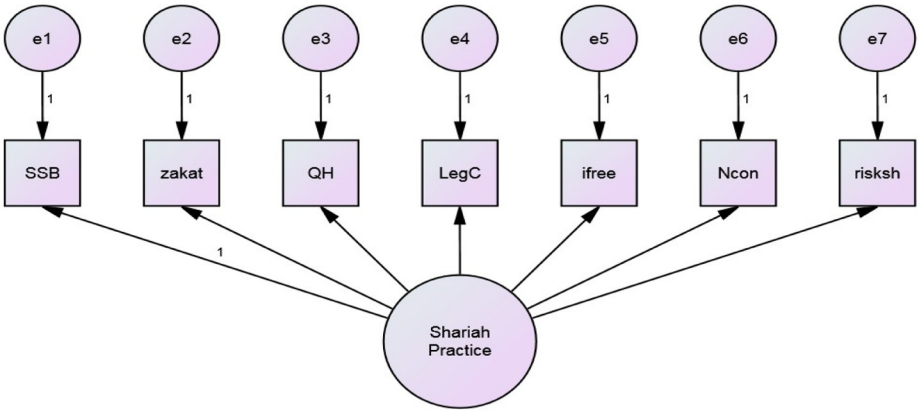

Figure 2.
Final model to measure *Sharia'h* practice

3.1.3 Model re-identification. Now this model has seven indicators of *Sharia'h* practice such as provision of interest-free services, QH[3], legal contract, risk sharing, approval of financial contracts by *Sharia'h* supervisory board and organization of zakat. The model includes seven observed and one latent variable. Accordingly, model has 13 parameters and 28 elements in correlation matrix. Thus, degree of freedom is 13 that renders our model overidentified. Kline (2011) mentions that model is required to be overidentified for estimation and testing the hypothesis about association among variables.

3.1.4 Model estimation and evaluation. The estimated results for the model in Table III indicate that value of goodness-of-fit index (GFI) and confirmatory fit index (CFI) values are 0.95 and 0.91, respectively. Both values are above the threshold value 0.9. The value of root mean square residual (RMR) is exactly 0.05. However, the *p*-value is insignificant and root mean square error of approximation (RMSE) is 0.09. The goodness of fit requires significant *p*-value and RMSEA should be less than 0.05. Thus, our results suggest that fit is not good.

However, by evaluating modification indices, we realize correlation between e_2 and e_3 is high at 19.62. After correlating the error 2 and 3, we repeat the estimation and findings in Table IV exhibit that the value of GFI and CFI are satisfactory at 0.97 and 0.96 above the threshold value 0.9. The RMR value has declined up to 0.03. However, the *p*-value is still insignificant at 0.01 that is less than 0.05 and the value of RMSEA is 0.06 that is greater than 0.05. This suggests that still fit is not perfectly good. Therefore, we again evaluate the modification indices that reveal high correlation between e_1 and e_4. Now we correlate error 1 and 4. The estimated results in Table V show that *p*-value is highly significant, the value of GFI and CFI are highly satisfactory at 0.99 and 1 above the threshold value 0.9. The RMR value has further declined up to 0.02 and the value of RMSEA is 0.00 that is less than 0.05. This suggests that fit is perfectly good. In sum, initially we find that fit of the model is not

Results of fit of model	GFI	CFI	RMR	*p* value	RMSEA
	0.95	0.91	0.05	0.000	0.09
Covariance among errors					
Results of		e3 <————> e4			4.95
Modification Indices		e2 <————> e3			19.62
		e1 <————> e4			17.37

Table III. Results of model fit

Results of fit of model	GFI	CFI	RMR	*p* value	RMSEA
	0.97	0.96	0.03	0.01	0.06
Covariance among errors					
Results of Modification Indices		e3 <————> e7			4.009
		e2 <————> e3			15.982

Table IV. Results of model fit

GFI	CFI	RMR	*p*-value	RMSEA
0.99	1.00	0.002	0.66	0.000

Table V. Final results of model fit

good, then we explore the reason and find out that the correlation between errors e_2 and e_3 is high. Similarly, we also find high correlation between errors e_1 and e_4. To solve this problem, we correlate errors and re-estimate the model.

As a result, fit of the model improves.

3.2 Results of simultaneous equation modeling multiple regression relationship

Table VI represents summary of multiple linear regression and overall fit statistics. It is visible that the value of adjusted *R* square of our model is 0.37 with the *R* square = 0.38. It says that 38 per cent variation in dependent variable can be explained by the independent variables. The *F*-test has the null hypothesis that there is no relationship between variables. Results indicate that the value of *F*-test is highly significant.

Therefore, we conclude relationship between dependent and independent variables of our model.

Moreover, estimated results provide the value of standardized coefficient that exhibit the relative value of each independent variable. First, we understand that provision of interest-free services, legal contract and no conflict at Islamic banks are significant predictor of *Sharia'h* practice. These findings are in line with the theory of Iqbal (1997); Iqbal and Mirakhor (2006) and Iqbal and Tsubota (2006). The better practice attributes to the State Bank of Pakistan (SBP) that has taken various steps to ensure *Sharia'h*-based services at Islamic banks. Moreover, recently SBP has lunched two standards prescribed by Audit and Accounting Organization of Islamic Financial Institutions (AAOIFI). Second, we find that the impact of provision of interest-free services and legal contract is higher than no conflicts on *Sharia'h* practice.

In contrast, risk sharing, zakat and *Sharia'h* supervisory board are insignificant and have less impact on *Sharia'h* practice. These estimated results are inconsistence with the theory of Farook (2007), Greuning and Iqbal (2008) and Mohieldin *et al.* (2012). It is because Islamic Banking Industry has shortage of risk sharing financial instruments and do not have comprehensive regulatory framework. The emerging industry also lack human capital. These are the great obstacles in the way of practicing *Sharia'h* by Islamic banks.

Moreover, the unstandardized relationship tells change in dependent variable per unit change in independent variable. The values of unstandardized coefficient indicate that by one-unit increase in provision of interest-free services, legal contract and no conflict, the *Sharia'h* practice will increase by 33, 27 and 17 per cent, respectively. On the other hand, the one-unit increase in risk sharing decreases the *Sharia'h* practice by 5 per cent. The one-unit

Table VI.
Results of SEM multiple regression (full sample)

Independent variables	Unstandardized coefficients	Standardized coefficient	Standard error	Significance	VIF
Interest free	0.332	0.379	0.056	0.000	1.70
Risk sharing	−0.054	−0.06	0.055	0.325	1.57
Legal contract	0.272	0.269	0.060	0.000	1.48
No conflict	0.173	0.194	0.051	0.001	1.42
Sharia'h board	−0.040	−0.039	0.059	0.496	1.42
QH	0.038	0.055	0.037	0.305	1.20
Zakat	−0.006	−0.008	0.046	0.213	1.34
R-squared	0.389		Adj-*R* squared	0.373	
F-statistics	23.653		Significance	0.000	

increase in role of *Sharia'h* supervisory board and organization of zakat by Islamic banks in Pakistan decrease *Sharia'h* practice by 4 per cent and less than 1 per cent, respectively. In addition, the value of VIF that is less than 10 for all variables indicates that data do not have any problem of multicollinearity.

Furthermore, we investigate whether empirical results vary between respondents working in FFIB and respondents working in IBCBs. Table VII presents the results for the sample of responses from FFIB. It is observed that signs of the coefficients remain same for all variables excluding zakat. The positive sign of unstandardized coefficient for zakat indicates that FFIB are practicing *Sharia'h* by offering zakat which is one of the five pillars of Islam. In fact, a staff discussion at FFIB reveals that employees at FFIB are frequently offered trainings consequently, they are well trained and have enough knowledge about zakat managed by Islamic banking. However, the level of significance remains same for all variables in the case of FFIB sample as full sample. Similarly, we do not find any significant difference in the values of *R*-square, adjusted *R*-square and *F*-statistics.

We repeat the estimation for the sample of respondents from IBCB. The results are presented in Table VIII.

We see that the signs of coefficients remain same as full sample except *Sharia'h* board. It means, according to perceptions of respondents at IBCB, *Sharia'h* supervisory

Independent variables	Unstandardized coefficients	Standardized coefficient	Standard error	Significance	VIF
Interest free	0.348	0.385	0.068	0.000	1.48
Risk sharing	−0.019	−0.022	0.063	0.768	1.38
Legal contract	0.245	0.225	0.080	0.003	1.40
No conflict	0.185	0.212	0.064	0.004	1.38
Sharia'h board	−0.095	−0.104	0.069	0.167	1.46
QH	0.026	0.042	0.042	0.537	1.21
Zakat	0.054	0.067	0.057	0.343	1.29
R-squared	0.374		Adj-*R* squared	0.347	
F-statistics	13.911		Significance	0.000	

Table VII. Results of SEM multiple regression (sample of respondents from FFIB)

Independent variables	Unstandardized coefficients	Standardized coefficient	Standard error	Significance	VIF
Interest free	0.306	0.366	0.101	0.003	2.04
Risk sharing	−0.104	−0.117	0.108	0.340	2.05
Legal contract	0.263	0.284	0.097	0.008	1.54
No conflict	0.151	0.178	0.089	0.094	1.53
Sharia'h board	0.067	0.060	0.114	0.559	1.45
QH	0.038	0.048	0.077	0.623	1.34
Zakat	−0.075	−0.095	0.083	0.368	1.52
R-squared	0.361		Adj-*R* squared	0.311	
F-statistics	7.177		Significance	0.000	

Table VIII. Results of SEM multiple regression (sample of respondents from IBCB)

board positively affects the *Sharia'h* practice at IBCBs. In addition, it is worth mentioning that the sign of unstandardized coefficient for zakat do not change for the sample of respondents from IBCB. In fact, respondents from IBCB are not well aware of *Sharia'h*-based banking operation. Nevertheless, it is observed that level of significance has changed from 1 to 5 per cent for interest-free services, indicating that marginal impact of interest-free services is lower in this sample of respondents. It implies that perceptions of respondents in IBCB regarding *Sharia'h* practice are comparatively lower. Similarly, the levels of significance for legal contract and no conflict have changes from 1 to 10 per cent. The impact of *Sharia'h* board turns out to be insignificant in this sample. It is noted that similar to the full sample, the value of VIF remains very low for both sample of FFIB and IBCB. It specifies that even after separating, data set has no problem of multicollinearity.

In sum, sub-sample analysis shows that overall results are similar, but the perceptions of respondents at IBCB are in less favor of *Sharia'h* practice as compare to their counterparts. It is because that staff members at IBCB have not relevant knowledge, and most of them have been transferred from conventional banks branches without adequate training.

4. Conclusion

In this study, we measure *Sharia'h* practice at Islamic banks. We analyze primary data collected from 63 branches of Islamic banks in federal capital Islamabad. To accomplish the task of research, we consider provision of interest-free services, legal contract, QH, risk sharing, no conflict, role of *Sharia'h* supervisory board and organization of zakat. This study finds that Islamic banks are providing interest-free services, conflict-free environment, legal contracts and transactions. It is attributed to efforts of State Bank of Pakistan (SBP). Indeed, SBP has taken various steps to ensure standardization and harmonization of Islamic Financial System. Therefore, we find that Islamic banks are practicing *Sharia'h* in terms of provision of services and legal contracts and transactions.

In contrast, estimated results expose that Islamic banks are not sharing risk, *Sharia'h* supervisory board is not performing its role flawlessly. Similarly, organization and distribution of zakat and QH is weak at Islamic banks. The reason behind it is three fold. First, Islamic banks are focusing on sale contract especially on *murabahah* and neglecting those financial contracts that offer risk sharing. Second, comprehensive regulatory framework for Islamic banking is still missing. Third, being an emerging industry, Islamic banks lack human capital. These are obstacles in the way of running Islamic banks with true spirit. Therefore, results designate no *Sharia'h* practice at Islamic banks regarding risk sharing, provision of QH and organization of zakat.

It is concluded that Islamic banks are providing interest-free services and legal contract with the support of State Bank of Pakistan, however, not sharing risk distributing zakat in Pakistan. This suggests that Islamic banks should expand their activities and develop new modes of financing confirmed with sharia principles. Moreover, State Bank of Pakistan should ensure separate regulatory framework that will enable Islamic banks to provide QH, to organize and allocate zakat. Sample selection of just one city is the limitation of this study. Further research can be undertaken by using wider sample of banks as well as respondents. Other techniques can be used to answer the research questions of this study.

Notes

1. According to Wall Street Journal (October 1, 2012), global financial crisis 2008 costs 10 million people their saving deposits and their jobs. The estimated loss is $15tn.
2. *Mudarabah* is a partnership in which one or more partners are capital provider and the other is capital user. Capital provider has no right to manage. The loss is born by capital provider unless negligible of misconduct by capital user is found. Profit is shared with capital user only at profitable sale. However, capital user cannot get benefit from appreciation in value of assets.
3. Interest-free loans to poor class of a society.
4. *Sharia'h* Supervisory Board.
5. Accounting and Auditing Organization of Islamic Financial Institutions.
6. This sermon was delivered on the Ninth Day of Dhul-Hijjah 10 A.H. in the "Uranah valley of Mount Arafat" in Mecca by the Prophet Muhammad.

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Further reading

Islamic Banking Bulletin (2014), *Islamic Banking Bulletin*, State Bank of Pakistan.

Appendix. Survey items

Section 1

(1) Select your age

☐ Under 25 ☐ 25 to 35 ☐ 35 to 45 ☐ Over 45

(2) Select your education

☐ Metric ☐ Under graduate ☐ Graduate ☐ Post graduate ☐ if any other please specify

(3) Select type of your Bank

☐ Full-fledge Islamic Bank ☐ Islamic branch of conventional bank

(4) How are you connected with Islamic bank, please select one

☐ Employee ☐ Manager ☐ Customer

Section 2

(1) Do you agree that Islamic banking is:
- based on Islamic teaching?
- truly working according to *Sharia'h* principles?
- giving more importance to norms of Islam than customer's preferences?
- investing only in those businesses, which have no higher risk?
- not involving in Haram businesses for example gambling, tobacco, alcohol, weapons and cinema.
- offering financial contracts that are approved by SSB[4]?
- following AAOIFI[5] standard of accounting and auditing procedures?
- promoting Islamic life style?

(2) Do you agree that:
- products and services offered by Islamic banks are Sharia'h based?
- *Sharia'h* board acts carefully while issuing different products?

Section 3

(1) Do you agree that Islamic banks:
- are operating on profit-loss sharing bases?
- are operating on interest-free bases?
- are operating on risk sharing bases?
- are free from conflict, dissatisfaction and exploitation?
- do not exploit customers?
- do not adopt misleading advertisements?
- do not adopt Haram methods of earning profit?
- properly reflect the values of Islam?

(2) Do you agree that Islamic banks:
- offer poor easy access to interest free loan?
- supervise Zakat, Sadaqat and donations.
- contribute in decreasing income inequalities?
- contribute in removing poverty?
- contribute to decrease in unemployment?
- contribute to economic development?
- contribute to promote fairness in financial business?
- are providing an alternative finance system?
- are achieving the objective of *Sharia'h* such as social welfare.

Theory of Islam Banking	Reference from Qur'an and Hadith
Prohibit interest on loan and allow trade	"Allah permits trade but forbids usurious gain." (Qur'an 2:275)
Follow justice without discrimination in all matters	". . . stand out firmly for justice, as witnesses to Allah, even against yourselves, or your parents, or your kin, and whether it be (against) rich or poor." (Qur'an 4:135)
Rights are limited to private property	". . . to Allah belongs all that is in the heaven and on earth. . ."(Quran3:129)
Fulfill responsibilities to maintain relationship at workplace	"Allah does command you to render back your trusts to those to whom they are due. . ." (Quran 4:58)
Reward cannot be received without efforts	". . . Man can have nothing but what he strives for. . ." (Quran 53:39)
Negotiation must be true	". . . make your utterance straightforward. . ." (Qur'an 33:70)
Equal chances without discrimination in employing, purchasing and selling	"Arab has no superiority over non-Arab nor a non-Arab has any superiority over an Arab, also a white has no superiority over black nor a black has any superiority over white except by piety and good actions" Said by Muhammad (Peace be upon him) on last sermon[6]
Work should have excellent quality	"Allah likes that when someone does anything, it must be done perfectly well" Saying of Muhammad (Peace be upon him) (Sahih Muslim)
Compel to disclose known defect	"He who cheats is not one of us." Saying of Muhammad (Peace be upon him) (Sahih Muslim)
Encourage fair negotiations in transaction	". . . don't outbid one another in order to raise price . . . don't enter into a transaction when others have already entered into that transaction and be as brothers one to another." Saying of Muhammad (Peace be upon him) (Bukhari and Muslim)
Knowledge-seeking is very important	"The acquisition of knowledge is a duty incumbent on every Muslim, male and Female." Saying of Muhammad (Peace be upon him) (Sahih Muslim)
Sharing of wealth with needy	". . . of their wealth take alms, so that you might purify and sanctify. . ."(Qur'an 9:103)
Encourage brotherhood	"Give presents to one another for this would increase your mutual love" Saying of Muhammad (Peace be upon him) (Sahih Muslim)
Basic facilities should be available to every one	"A town in which a man goes to sleep hungry and wakes up hungry, loses the protection from Allah" Saying of Muhammad (Peace be upon him) (Sahih Muslim)
Prohibit from vast storage of precious metals and encourage circulation of wealth	"Those who hoard up gold and silver and spend it not in the way of Allah, unto them give tidings (O Muhammad S.A.W) of painful doom" (Qur'an 9:34)
Discourage hoarding, lavish spending and encourage wealth circulation	". . . Allah loves not the arrogant, the vainglorious (nor) those who are niggardly, enjoin niggardliness on others. . ." (Quran 4:36-7)
Orders for payment of zakat	". . . give the obligatory charity (Zakat). . ." (Qur'an 2:3, 2:43, 2:83, 2:110, 2:177, 2:196, 2:215, 2:219, 2:254, 2:262, . . .)

Sources: Holy Qur'an and Rice (1999)

Table AI.
Theory of Islamic baking with reference to Qur'an and Hadith

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