S
E
R

Stanford Economic Review

COMMENTARY: Performance, Islamization, and Trust: Pakistan's Evolving Banking Sector

January 3, 2025

By Fasih Zulfiqar, IBA Karachi

Out of the global Muslim population of 1.6 billion, just 14% utilize banking services. In Pakistan, only 21% of adults had bank accounts as of December 2017. While there are multiple factors behind the low bank account penetration in Muslim-majority nations, religion plays a pivotal role.

The Quran, believed to be the word of God by Muslims, says, "those who consume interest cannot stand [on the Day of Resurrection] except as one stands who Satan is beating into insanity" (Quran 2:275). Citing this verse, the Federal Shariat Court of Pakistan (SCP) issued a directive in 2022 instructing the Government of Pakistan to begin removing interest (Riba or usury) from its economic apparatus by December 2027 to Islamize the country. Well before this judgment, the conventional banking industry was opposed to wealth concentration. To illustrate, in 1974, the government claimed that 22 influential families, possessing 66% of the country's industrial wealth and 87% of its banking and insurance, held dominion over Pakistan's industry.

These circumstances raise several questions: Under such unfavorable circumstances, is it possible for Pakistan to boost its financial inclusivity and hence economic development by getting people to trust the interest-based banking system? If so, how can trust theories explain this?

While Islam encompasses diverse belief systems, all sects in Pakistan regard Riba (interest) as incompatible with Islamic principles. Furthermore, surveys indicate religious precepts are imperative in Pakistanis' lives. However, although the share of Islamic banking in the overall banking industry increased from 2.3% in 2003 to 17.6% in 2021, there remains an adverse association between religion and confidence in banks among the Pakistani populace.

Beyond religion, confidence in banks is influenced by many other factors. Sociodemographic variables, such as an individual's gender, age, and education level, can also impact trust in banks. A study shows that the user characteristics of gender and age did not significantly impact trust, but the prior experience did.
Other studies endorse that banks' performances neutralize the effects of gender and age on trust in banks. Regarding the effects of education on trust in banks, the evidence is mixed. Some studies have found that education has a positive effect on trust in banks, as it increases financial literacy and reduces information asymmetry, whereas other studies show it has no significant effect, as it does not affect the perception of institutional quality. In the context of Pakistan's poor educational system, education having a null influence on trust in banks is an intuitive and plausible statement.

Qing Yang's study on China, a non-democratic country, demonstrates that trust in financial institutions is generated from their credibility and performance, even in the absence of democratic practices. Similarly, in African countries such as Botswana and Ghana, where several trust-building variables are absent, people still place trust in financial institutions. Similarly in India, during the 2008 financial crisis, trust in Indian banks declined more rapidly when their performance was deemed average.

Pakistan's banking system has passed through three critical stages: the 1970s nationalization, 1990s privatization, and the 2000s Islamization. The process of Islamization spurred the expansion of Pakistan's banking sector, with Pakistan's central bank setting an ambitious target to increase the share of Islamic banking to 35% by 2025. Furthermore, their deposit base has surged to Rs 5 trillion, representing more than one-fifth of the entire banking industry. To comparatively measure banks' performance during the nationalization and privatization periods, statistical methods have been conducted in the literature. For example, Hayat used Data Envelopment Analysis to measure banks' efficiency, and Khalid, using CAMEL analysis, showed liberalization and privatization of banks improved efficiency and public trust. Other works also support the finding that the privatization of banks led to improved performance and increased efficiency.

An analysis of the World Values Survey's Wave 7 data shows that the mean level of trust in Pakistan's banks increased by 16.6% between 2012 and 2018. This increase is statistically significant and coincided with a period when the Islamization of banks gained momentum, with even conventional banks opening windows for Islamic banking.

An ordered logit regression on World Values Survey data empirically suggests that religion is still negatively correlated with trust in Pakistani banks and Pakistanis trust banks more if they operate efficiently, especially after privatization. This trust, because it endures despite religious condemnation from Islamic scholars who label banks as religiously illegitimate, sets banks apart from most other institutions in Pakistan. A key reason is that as of June 2024 Islamic banks' assets account for only 18.8% of the total assets in the banking industry, while their deposits make up just 22.7% of the total deposits. Another reason is the growing critique of Islamic banking. Timur Kuran, Professor of Economics and Gorter Family Professor of Islamic Studies at Duke University, along with other Muslim critics contend that there is no fundamental difference between Islamic and conventional banks and banks' Islamization is merely a façade.

Pakistan's populace has come to not only let banks exist but also thrive, with 81% of total banking shares being owned by conventional banks–institutions called officially illegitimate. This remarkable example should set an example for other liberal institutions in other non-secular countries. For instance, Israel's public transportation system, which is essential for people and economic activity, during Shabbat. Although banned on the Shabbat in most parts of Israel, if it follows the example set by banks in Pakistan and works on insinuating itself deeper into the daily and economic affairs of Israeli society, by making Israelis dependent on the transportation system, then public buses might soon be allowed to operate on the Shabbat in most cities of Israel, if not all cities. As in the case of Pakistan's banking sector, efficiency and demand can triumph over religious concerns.