

PERCEPTIONS AND REALITIES: INVESTIGATING BARRIERS TO ADOPT ISLAMIC BANKING IN PAKISTAN

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Abstract

This study aims to identify the barriers to adopting Islamic Banking (IB) in Pakistan. This study is focused on three categories of banking customers: IB users, non-users, and those who use both IB and Conventional Banking (CB). We utilize qualitative methods include in-depth interviews with IB Managers, scholars, and focus groups of the three consumers types. Findings revealed several barriers to broad-based adoption of Islamic banking in Pakistan such as: Lack of Trust, high adoption costs, perception that IB and CB are similar, lower returns, the state bank of Pakistan's reliance on CB methods, and financial literacy gaps. This study stands out for its inclusion of focus groups with both users and non-users, as well as expert interviews, providing insights beyond literature review. Additionally, it offers user and non-user profiles valuable for customer segmentation and targeting.

Keywords: Pakistan, Islamic banking, Barriers, shariah, customer perception

1. INTRODUCTION

IB is an alternative form of banking that operates based on the principles of Islamic law (Sharia) and offers a range of financial products and services that are compliant with these principles. IB has a longstanding presence in Pakistan, dating back several decades, supported by substantial legal and operational frameworks designed to facilitate its operations alongside conventional banking. IB operates on the principles of Islamic finance, which prohibits the collection and payment of interest and promotes ethical and fair financial practices. Islamic banking in Pakistan has witnessed remarkable growth since its inception in the late 1970s (Iqbal & Molyneux, 2005). Despite the conducive environment created by the State Bank of Pakistan (SBP) to facilitate the establishment and growth of Islamic banks and Islamic banking windows within conventional banks (Iqbal & Molyneux, 2005), the adoption of Islamic banking in Pakistan faces various barriers. These initiatives reflect the government's commitment to promoting an Islamic financial system that adheres to Shariah principles, which prohibit interest-based transactions (riba) and promote risk-sharing, asset-backing, and profit-sharing arrangements.

Islamic banks (IBs) have not only gained popularity among Muslims but have also found a significant market in non-Muslim countries. This trend has been acknowledged by the Western banking market, which views Islamic banking as a profitable opportunity rather than a threat, leading to the establishment of Islamic banking windows by major players such as Citi Group and HSBC alongside their conventional operations (Warde, 2000). Interestingly, Islamic investment and holding companies have predominantly been established in non-Muslim countries, indicating a growing demand for Islamic financial products and services from both Muslim and non-Muslim investors (Khan & Mirakhor, 1990). In fact, non-Muslim investors are increasingly seeking Islamic banking products to diversify their portfolios and benefit from the strict and prudent lending practices associated with Islamic banks (Hesse et al., 2008). Muslim countries themselves have been actively working towards the adoption of Islamic principles in their financial systems. Iran and Sudan, for instance, have undergone significant economic restructuring to fully operate on Islamic financial systems. In addition, countries like Pakistan, Malaysia, Indonesia, and the United Arab Emirates (UAE) have

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witnessed the emergence of a robust Islamic banking market alongside their conventional banking networks (El Qorchi, 2005).

Research indicates that religion plays a crucial role in the adoption of Islamic banking, and there is a prevalent perception that Islamic banking products may not fully comply with Shariah principles. Currently, Islamic banks are striving to replicate conventional banking products by adapting them to conform to Shariah principles, rather than developing new products that are inherently grounded in Shariah principles. This adaptation is primarily driven by the limited investment opportunities available to Islamic banks (Roy, 1991). Consequently, Islamic banks may face challenges in providing added value to customers who already have access to a wide array of services offered by conventional banks. Moreover, they may encounter difficulty in attracting devout Muslims who may question the authenticity of Islamic banks' ability to deliver genuinely Shariah-compliant products to their intended target market (Wahab et al., 2007).

The Pakistani government has taken several steps to support the growth of Islamic banking, including the establishment of a dedicated regulator, the State Bank of Pakistan (SBP), to oversee the industry. The SBP has introduced various policies and initiatives aimed at promoting the development of Islamic finance, such as issuing guidelines for the operation of Islamic banks, creating a dedicated Shariah board to ensure compliance with Islamic principles, and establishing a national center for excellence in Islamic finance (State Bank of Pakistan, 2015).

In addition to government support, the increasing demand for Islamic financial services from individuals and businesses has contributed to the growth of Islamic banking in Pakistan. Islamic banking's focus on ethical and socially responsible finance, as well as its commitment to avoiding interest and other prohibited practices, have attracted many people in the country (Zaman & Jaffri, 2013).

Despite the global popularity of Islamic banking, its adoption has been slow in various countries, including Pakistan. The adoption of Islamic banking in Pakistan is crucial as it can provide financial services to a significant portion of the population that remains underserved by conventional banking. However, there are several barriers to the adoption of Islamic banking in Pakistan that require understanding and resolution.

The study of the barriers to the adoption of Islamic banking in Pakistan is timely and important because it has the potential to provide financial services to a large segment of the population that is currently underserved by conventional banking (Ahmed et al., 2016). Understanding these barriers is crucial for devising strategies to overcome them and promote the growth and adoption of Islamic banking in Pakistan (Rizvi & Syed, 2015). Islamic banking offers an alternative to conventional banking, addressing issues such as customer exploitation and unethical financial practices (Ahmed et al., 2016). It is perceived as a more ethical and fair form of finance, attracting individuals seeking an alternative banking system (Hussain & Rahman, 2018).

The study employs qualitative research design through conducting in-depth interviews with managers of both conventional and Islamic banks in Pakistan on key reasons holding back Islamic banking access and adoption. This interview data collected and analyzed using thematic analysis to identify the barriers to the adoption of Islamic banking in Pakistan. The findings of this study are stated in section 5 and 6, aim to improve understanding of the challenges faced by Islamic banking in Pakistan and provide insights into how these barriers can be overcome. Overall, this study contributes to the existing literature on the subject matter and also the practical development of Islamic banking in Pakistan.

2. LITERATURE REVIEW

Islamic banking is a banking system which is in accord with values, characteristics and ethics governed by Islamic shariah. Islamic banking involves in interest free banking concept and avoid unethical and unsocial practices while doing banking transactions. It takes in accounts investment of money in physical or tangible assets in contrast to the conventional banking system. By doing this practice IB help the countries to stabilized their economy, which is evident from global financial crises 2008. (State bank of Pakistan 2008) IB concept was firstly experimented by Egypt in 1963, it was under cover because of the fear of being seen as manifestation of Islamic fundamentalism due to political situation of that time. Later, OIC established Islamic development bank (IDB) in order to fund OIC member countries following Islamic shariah concept, interest free loans to governments. After that most of the Islamic countries started to adopt IB principles without any fear of global forces.(Ariff 1988).

The concept of IB is derived from Islamic shariah principles. According to Islamic shariah, IB should not allow themselves to deal in transaction involving interest/Riba. Quran also prohibits the concept of Riba which is evident in three different revelations.

Whatever loans you give, 'only' seeking interest at the expense of people's wealth¹ will not increase with Allah. But whatever charity you give, 'only' seeking the pleasure of Allah—it is they whose reward will be multiplied. (Surah e Ar-Rum, Surah 30, Ayat 39).

This verse emphasizes that interest deprives wealth of Allah 's blessings.

And [for] their taking of usury while they had been forbidden from it, and their consuming of the people's wealth unjustly. And We have prepared for the disbelievers among them a painful punishment. (Surah e Nisa, surah 04, Ayat 161).

This verse emphasizes that one who take or give interest will be punished by Allah.

Those who consume interest will stand 'on Judgment Day' like those driven to madness by Satan's touch. That is because they say, "Trade is no different than interest." But Allah has permitted trading and forbidden interest. Whoever refrains—after having received warning from their Lord—may keep their previous gains, and their case is left to Allah. As for those who persist, it is they who will be the residents of the Fire. They will be there forever. (Surah e Baqarah, surah 01, Ayat 275).

This surah establishes a clear distinction between interest and trade urging Muslims to take only principle amount and to forgo even principle amount if the borrower unable to repay. Furthermore, shariah restrict IB to not deal in the transection having elements of Gharar or Maiser. They should invest capital in those investment avenues which are in the boundaries of Shariah principles. IB operations should be based on sharing risk on investment which can arise or decrease during the transaction periods.

Islamic banking transaction are mostly seen three parts of the world which include Middle East, Southeast Asia and south Asia. middle east is highly populated by Muslims countries is called as motherland of IB and finance. IB sectors is supported by government and states institution in middle east. Refereeing to the south east Asia three countries namely, Singapore, Indonesia, Malaysia are introducing most recent version of IB and finance in their countries. On other hand Sudan is adapting IB practices in their region also in order to attract business and finance from middle east countries. (Mansoor Khan and Ishaq Bhatti 2008). Islamic banking is largest sector in the Islamic finance industry, contribute 69%, or USD 1.992 trillion worldwide. There were 526 Islamic banks by 2019. The top 3 markets of Iran, Saudi Arabia, and Malaysia only have 63% of the Global Islamic Banking Assets, whereas Morocco is growing its Islamic banking system .by 2019 morocco had doubled assets in IB and finance (Mordor intelligence 2021).

Pakistan being one of the largest Islamic countries has started Islamic banking in late 1970s and is known for its pioneering position in formal Islamization of its banking system.(Lee and Ullah 2011). According to Islamic banking bulletin 2022 in terms of amount, the asset base of IBI enlarged by Rs 836 billion and was recorded at Rs 6,781 billion by end June, 2022. Market share of IBI's assets in overall banking assets stood at 19.5 percent by end June, 2022 in Pakistan.Understanding customer perception and acceptance is important for the growth and sustainability of Islamic banking in Pakistan. Several studies (Haque et al., 2018; Khan et al., 2020) have explored customer attitudes, preferences, and awareness regarding Islamic banking products and services. Factors such as religious beliefs, trust, and satisfaction with Islamic banking offerings influence customer acceptance and adoption. The adoption of Islamic banking as an alternative financial system has gained momentum globally. Consumer preferences and choice play a significant role in determining the adoption of Islamic banking over conventional banking (Hasan et al., 2017; Abdullah et al., 2020). Factors such as religious beliefs, trust, ethical considerations, and perceived benefits associated with Islamic banking influence individuals' decisions. Understanding consumer preferences and choice is crucial for banks to tailor their products and services accordingly.

Awareness and knowledge about Islamic banking are also important for its adoption (Iqbal et al., 2018; Ahmed et al., 2021). Research highlights the importance of education and information dissemination to enhance awareness among the general public. In comparison, conventional banking has a longer-established presence, resulting in higher

awareness levels. Efforts to bridge the knowledge gap and increase awareness about the principles and benefits of Islamic banking can influence adoption rates.

Comparing the financial performance of Islamic banking with conventional banking provides insights into their respective strengths and weaknesses (Hassan et al., 2019; Siddiqui et al., 2022). Evaluating the performance of Islamic banking in terms of profitability, efficiency, and risk management can help assess its competitiveness and sustainability. Understanding the financial performance of Islamic banking institutions contributes to the overall evaluation of their adoption in comparison to conventional banking.

3. DESIGN AND METHODOLOGY

3.1. Approach

The research methodology of qualitative research was used to explore the barriers to the adoption of Islamic banks in Pakistan. This methodology was chosen because it allowed the researcher to gain in-depth understanding and insights into the experiences, attitudes, and beliefs of the participants.(Dr Sharon Golden 2017). Furthermore, the reason to adopt qualitative research can be described by its ability to gain a more nuanced understanding of the experiences of individuals in the context of their own culture and social norms. In the case of Islamic banking in Pakistan, the cultural and religious significance of this type of banking is important to consider in order to understand why it may not be as widely adopted as conventional banking practices (Creswell and Creswell 2013).

3.2. Sample and data collection

The data collection process involved conducting semi-structured interviews with 7 individuals who had personal experience with or knowledge about Islamic banking in Pakistan. The participants were selected through purposive sampling and included customers of both conventional and Islamic banks, bankers, and financial experts. The interviews were conducted in-person and recorded for later transcription and analysis. These interviews were ranging from 12 to 20 minutes. At the start of interview the interviewees were asked to record the interview and assured them their confidentiality of identities.

3.3 Sample Framework

The sampling method is purposive sampling, which involves selecting participants who possess relevant knowledge and experience in the field of Islamic banking in Pakistan. The sample consists of:

- i. Islamic Banking (IB) Bankers: Experienced professionals working in Islamic banks in Pakistan, such as branch managers, relationship managers, or product development managers.
- ii. Conventional Banking (CB) Bankers: Professionals working in conventional banks in Pakistan who have knowledge of Islamic banking practices or have interacted with Islamic banking.
- iii. Teachers with IB Background: Educators who have a background in Islamic banking and have taught relevant courses or conducted research in the field.
- iv. Islamic Scholars: Scholars with expertise in Islamic law and its application to the banking and finance sector.

3.4. Data analysis

The data collected was analyzed using thematic analysis, a commonly used method for analyzing qualitative data. The first step in the data analysis was to transcribe the interviews and organize the data into themes. The transcripts were read and re-read several times to identify recurring patterns and themes. These themes were then used to categorize the data into meaningful categories. Once the data was categorized, the next step was to identify the barriers to the adoption of Islamic banking in Pakistan.

Table 3.1: Respondant Profile

<i>Individual</i>	<i>Description</i>
Banker of IB (2)	Manager of Meezan Bank and Alied Islamic Window Bank, 35-40 Years of Age, 10-15 Years banking Experience
Banker of CB (2)	Manager of MCB and Internal Auditor of HBL, 30-35 Years of Age, 07-10 Years banking Experience
Teachers (2)	Faculty in finance with IB background, 30-35 Years of Age, 08-10 Years Teaching Experience.
Islamic Scholar (1)	PHD Scholar in Islamic fiance and Alim, with 6 years teaching Experience.

3.5. Interview Questions

- i. Why customers can not differentiate conventional banks from Islamic banks?
- ii. It have been seen that CBs have attracted customers more productively then IBs, why?
- iii. What are the customer criteria's for selecting the Banks?
- iv. IBs are told to be Shariah compliant so the customer inclination that should be achieved is not attained then what is the reason behind it.
- v. Why are IBs struggling to aware the population of the Pakistan?
- vi. Islamic banks since the introduction in Pakistan are achieving market share at slow pace what do you think where are the problems.
- vii. Do you feel that our educational institutes are playing leading role in spreading Islamic Banking knowledge to students at large?
- viii. What is the perception of Islamic Banks amongst the consumer?
- ix. What is government doing for promoting Islamic banking system in Pakistan
- x. People are not getting interest in Islamic banks as compared to conventional banks what do you think what can be the problem?

4. Thematic Analysis

During the qualitative research, experts in the field of Islamic banking in Pakistan were interviewed to gather their opinions and insights about the current state of the industry, as well as the major challenges it is facing. The experts were also asked about consumer response to Islamic banking and their concerns about it. The responses from these interviews were transcribed and analyzed, revealing several themes that emerged from the data. These themes included religion, customer service, banking products, profit-loss sharing systems, customer awareness and lack of Training. These themes represent important factors that influence the adoption and success of Islamic banking in Pakistan, and provide valuable insights for improving the industry's performance and addressing consumer concerns. By identifying and addressing these themes, the industry can work towards building a more sustainable and responsive system that better meets the needs and expectations of its customers.

The implementation of Shariah principles and regulations can make the Islamic banking system more expensive as compare to CB. Regarding this matter, as noted in interview with respondent Q:

“We have to follow Sharia Rules and Regulations into Islamic Finance System which must need strict supervision, much check and balance, Sharia Audit must be done for it with normal audit and more legal formalities with normal formalities resulting in increasing the cost and decreasing the profit ratio as compare to the conventional banks and normally the customers take into the banks which give them more profit.”

Many researches have been conducted to study economic factors while selecting conventional banks. The respondent Q statement more similar with the research of (Gait & Worthington, 2008) concludes conventional banks sees for profitability like more return and lower service charges while selecting bank. On the other hand, the respondent S share his knowledge about the Insufficient Islamic Knowledge of the Islamic Bank Employees so it create the perception of complexity and difficulties to understanding the IB system for customers:

“The facing faculty has the same educational background like the conventional bank employees so they are not able to teach the mechanism of Halal Method for earnings in Islamic Banks they are in lack of knowledge about financing method with Ijarah, Muzarabah or Musharika. Therefore, the customers look the both as same system.”

He further said about the services: “It can be said. Actually conventional banks are old and giant industries and the Islamic banks are infant as compare to conventional banks. So, the conventional has capacity to provide better services than Islamic.”

In the same context of above the respondent J mentioned that:

“In my opinion and as the wise said “Old is Gold” I can link it to History. After the fall of Ottoman Empire, when Europe Empire takes over they prevail the financial system which was already in running from the last three centuries due to standard rules and regulations and they found it a Well Trained System and if we talk about the

Islamic Financial System so it is new born system as compare to the old conventional system as it comes in 1963 in Egypt and comes into Pakistan into 2002 or 2006.”

Additionally, respondent M was more concerned about the number of Islamic banks and branches in the country is still relatively small compared to conventional banking institutions:

“Another reason for not growing the Islamic Banking is less branches and low networking as we talk about the Islamic Banking Branches so they are about 300 to 400 but if we took at the conventional banking branches so they are about 1800 which result in having branch closed to door step and many people found it easy to deal with on door step.”

Respondent K more concerned about the experience and attraction ability of CB:

“If we talk about Islamic point of view so the person has religious mind will definitely choose the Islamic Banking system but there are many salesman, managers who make the customers satisfied to choose the conventional banks after giving than fringe benefits like free check books free ATM cards and highest profit ratio so the customers prefer to deal with conventional banks than Islamic Banks.”

Apart from this, a recent study conducted by (Al-Ajmi, Abo Hussain, and Al-Saleh 2009) in Bahrain spotted the position of religious factor while choosing bank. (Al-Ajmi, Abo Hussain, and Al-Saleh 2009) described that the previous study done by (Metawa and Almosawi 1998) have limitations which were directed by introducing five different factors while choosing bank. This study conclude that through all three sub samples the service quality, friendly staff and competent staff were significant drivers for bank selection.

Conventional banks may offer more diverse financial products and services, such as credit cards, personal loans, and mortgages, while Islamic banks provide Shari'ah-compliant financial solutions that align with Islamic principles. Some customers may prioritize convenience and accessibility, while others may prioritize ethical and religious values. Ultimately, it is up to the customer to determine which banking system is more suitable for their financial goals and beliefs.

Finally respondent O mentioned that:

“It depends upon the objective of the customer that what he wants so if he is profit oriented and wants more money whether it is Halal or Haram so the facing officer directs him to deposit the money into conventional banking system and if the customer has religious mind and he wants Halal Profit whether it is less or more so in that case the facing officer leads him to deposit money into Islamic Banking System.”

The above overall experts interviews showed the common factors but with the good degree of awareness and knowledge they have about the Islamic banking. In the subsequent section, we will explore the perceptions of customers as gathered through focus group discussions.

5. RESULTS AND DISCUSSION

The aim of this research was to identify the barriers that customers face while adopting Islamic Banking (IB) in Pakistan. The findings of this study reveal several key barriers to the adoption of Islamic banking in Pakistan, including the trust factor, high cost of adoption, perception that Islamic banks are the same as conventional banks, less return, dependence of the State Bank of Pakistan on conventional banking methods, and lack of financial literacy. One of the prominent barriers identified in this study is the trust factor. Customers may have doubts about the authenticity and compliance of Islamic banking products with Shariah principles. This lack of trust can hinder the adoption of Islamic banking as customers may prefer to stick with conventional banks where they perceive the operations and products to be more transparent and reliable. The high cost of adopting Islamic banking is another significant barrier highlighted in this study. Customers may perceive that the costs associated with Islamic banking, such as account maintenance fees or transaction charges, are higher compared to conventional banking. This perception can deter customers from switching to Islamic banking, especially if they do not see a significant difference in the services offered. Islamic banks need to address this perception by clearly communicating the value proposition of their products and services and demonstrating that the benefits outweigh the costs.

The perception that Islamic banks are the same as conventional banks is another barrier identified in this study. Customers do not perceive Islamic banks to be fundamentally different from conventional banks in terms of their offerings and operations. This perception arises from the practice of Islamic banks adapting conventional banking products to comply with Shariah principles, rather than developing new products grounded in Shariah principles. The study also highlights the issue of less return as a barrier to the adoption of Islamic banking. Customers perceive that the returns on investments or deposits in Islamic banks are lower compared to conventional banks. The dependence of the State Bank of Pakistan on conventional banking methods is another barrier identified in this study. The regulatory environment and policies in Pakistan may be more favorable towards conventional banking, which can create challenges for Islamic banks to operate and expand their services. Islamic banks need support from the regulatory authorities to create an enabling environment that promotes the growth and adoption of Islamic banking.

Lack of financial literacy is identified as a barrier to the adoption of Islamic banking in Pakistan. Many customers do not have sufficient knowledge and understanding of Islamic banking principles and products, which can hinder their adoption.

6. CONCLUSIONS

This research article on the barriers towards the adoption of Islamic banking in Pakistan highlights several critical factors that hinder the growth and development of Islamic banking in the country. The study identifies a lack of awareness of Islamic banking product, high cost of adopting IB, perception that “Islamic bank and conventional banks are same”. Furthermore, less return, dependence of state bank of Pakistan on conventional and less trained front employees of Islamic banks as the main barriers to the adoption of Islamic banking.

Addressing the barriers to the adoption of Islamic banking in Pakistan is essential for the growth and development of this sector. By building trust, differentiating from conventional banks, managing costs, providing competitive returns, overcoming regulatory challenges, and enhancing financial literacy, Islamic banks can effectively attract and retain customers. Through these efforts, Islamic banking can flourish, contributing to the overall financial landscape and promoting ethical and Shariah-compliant financial practices in Pakistan.

7. FUTURE RECOMMENDATIONS

The findings of the study suggest that addressing these barriers is crucial for promoting the growth of Islamic banking in Pakistan. Increasing public awareness and education about Islamic banking, expanding the range of Shariah-compliant investment opportunities and Islamic banking products and services, and creating a clear and consistent regulatory framework for Islamic banking are essential steps towards promoting the wider adoption of Islamic banking in Pakistan.

Therefore, policymakers, regulators, and banking institutions need to work together to overcome these barriers and create an enabling environment for the growth and development of Islamic banking in Pakistan. Doing so will not only promote financial inclusion but also contribute to the economic development of the country by mobilizing Shariah-compliant resources towards productive economic activities.

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