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QUALITATIVE RESEARCH

A Critical Analysis of Profit Distribution Practices by Islamic Banks in Pakistan

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Abstract

Purpose: This paper critically and empirically evaluates profit distribution practices of Islamic banking institutions (IBIs) in Pakistan for the period of 2015–2024. In this context, the State Bank of Pakistan (SBP) issued a circular in 2012 aimed at strengthening transparency and standardization in profit-sharing mechanism adopted by the IBIs. This study empirically evaluates the outcomes of profit-sharing regarding implications for enhancing equitable justice in the economy.

Design/Methodology: Specifically, this study addresses the underlying issue by gathering the opinion of different stakeholders through expert interviews with Shariah advisors, bankers and regulators, and a structured questionnaire on pool management, profit and loss sharing mechanism, and issues related to Hiba distribution. To evaluate the profit and loss distribution mechanism among the Islamic banking sector in Pakistan, the study employs a mean difference t-test that quantify the performance and distribution of key factors from 2015 to 2024.

Findings: The profit-sharing ratios between the bank and depositors confirm significant differences, indicating lack of standardization across different banks. The results show that mean Mudārib share remained significantly higher than the depositors' share in every year except for 2016. The overall paired t-test results indicate a highly significant difference, reflecting that the average share of Mudārib (23.7) substantially exceeds the average share of Rabb-ul-Māl (12.2). Moreover, Islamic banks in general fall short to give detailed disclosures of investment pools, thus, limiting the transparency of the IBIs.

Originality: The literature highlighting the issues and challenges in implementing the pool management and profit distribution framework, especially in achieving the objectives defined in SBP's framework, is limited. Furthermore, no research has evaluated the framework for transparency and standardization of the processes involved in the management of deposit pools and the distribution of profits among various categories based on the size and tenor of the deposits. To this end we extend the ongoing debate to the aspect of

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equity that is the hallmark of Islamic banking and finance as compared to conventional finance.
Implications: These findings are expected to strengthen transparency, promote fairness, and ensure consistency in profit distribution, which will also ensure depositor confidence and aligning practice with the objectives of Islamic law.
KAUJIE Classification: K2; I31; H54; L43
JEL Codes: G21; G24; G28; G32; Z12

INTRODUCTION

Islamic banking is a financial system based on the principles of Shariah, which prohibits the charging or paying of interest (ribā) and promotes risk-sharing and ethical banking practices. In Pakistan, Islamic banking has experienced visible growth over the past few decades, with an increasing number of people seeking this alternative form of banking (Shaikh, 2025). Pakistan was among the pioneers who worked to build the conceptual framework of Islamic economics and finance (Bhatti et al., 2024). But, it lagged behind even the countries like Oman that initiated the process in 2012 due mainly to the policy and governance failures. Since the second stage launch of Islamic banking in 2002, working parallel with the interest-based financial system, Pakistan could achieve around a 22% threshold of Islamic banking in total banking industry assets in the country (Saleem et al., 2024). However, deposits took an even bigger percentage at 24.9%, while Islamic banking assets made up 20.6% of the entire banking industry in terms of market share. Year-over-year growth was strong, with assets increasing by about 23.1%. By December 2022, Islamic banking's market share had increased to 26% in terms of financing and 22% in terms of deposits (SBP Bulletin Dec, 2024).

Furthermore, in order to give pre-agreed profit rate to some depositors, and to remain competitive in the market by offering a competitive rate of return, the Islamic banks started to use discriminately Hiba (giving the gift) to any particular depositors instead of giving to all depositors of the category (Abdul Rahim, 2025). Further, Hiba granted to respective depositors was not disclosed, despite disclosure being a basic requirement for conducting a valid Mudārabah-based business. Such malpractices caused injustice to small depositors who were paid a lesser amount of return as compared to priority deposits of a larger size. It also caused noncompliance with Shariah principles. Integrity concerns relating to Islamic banking began to emerge as the general public of Pakistan is generally sensitive to faith compliance.

In addition, SBP (2012) in its financial stability review evaluates the soundness, resilience, and risks facing Pakistan's financial system, noted that policies of Islamic banking relating to profit distribution were not transparent and lacked uniformity. The SBP also highlighted that for Islamic banking, it was obligatory to share profit and loss with the investors of the funds. Further, to enhance the trust of the depositors, Islamic banks were instructed to pay a minimum rate of return to Rabb-ul-māl based on a formula based on the SBP policy rate (SBP, 2008). It was considered against the Shariah injunctions on Mudārabah (Farooq & Zafar, 2024). Further, Mahar et al. (2024) document that a formal policy should be formulated by SBP on profit and loss distribution mechanisms to ensure

uniformity and standardization in profit distribution, financial disclosures, and the overall financial reporting system. Therefore, to overcome the issues in the profit system, the SBP introduced a formal framework for pool management and profit distribution in November 2012 (SBP, 2012).

Issues in the Deposit Management System and SBP steps for their Resolution

Islamic banks are in practice of creating a specific pool for a specific depositor to arrive at a committed rate of return on a deposit. The creation of a pool to provide a fixed return to a depositor at the cost of other depositors is Shariah is unjust and Shariah non-compliant practice. Islamic banks were instructed to frame a profit and loss distribution policy in compliance with the instructions of SBP for the creation of one or more asset pools financed by Mudārabah based deposits, the bank's equity, and the current accounts, clearly specifying investment strategies, objectives, and risks involved for each pool (SBP, 2012b). Justification for allocating different types of deposits to different pools, profit sharing ratios, and bases of assigning weightages to deposit slabs was also required to be documented. Each pool is assumed as a virtual enterprise having its assets, liabilities, income, and expenses. Moreover, the recording of all transactions for each pool should be ensured separately. Equity including current accounts if any of Islamic banks deployed in different pools should be in the reconciliation of the total equity of the bank (Rhoudri & Benazzou, 2023).

The SBP's instructions through their circular in 2012 on pool management were a step forward in deposit management to improve the Shariah compliance level, resulting in fair treatment of bank and investment account holders. The introduction of profit equalization reserves (PER) and investment risk reserve (IRR) in the pool management framework was to ensure profit smoothing and manage losses, if any. Ninety percent of the income earned by PER and IRR accounts balance must be credited to the respective account (Rouetbi,2023).

Thus, this study aims to explore whether the framework addresses all aspects relating to justice and equity, and has been successful in addressing issues and challenges in profit distribution, bringing transparency and standardization to Islamic banking practices. A crucial aspect regarding Shariah compliance is ensuring justice in giving returns to different categories of depositors while ensuring compliance with the Mudārabah principles. Discussing and analyzing this question is vital as issues and challenges, standardization and transparency, Shariah conformity, and justice in the distribution of profits among investment accountholders could be helpful to enhance the integrity and outreach of Islamic banking in Pakistan.

Gap Analysis and Scheme of the Study

Deposits' pool management by Islamic banks is among the areas least explored by researchers and academia. A deep perusal in the available literature reveals that none of the studies have discussed and analyzed Shariah conformity in the practices and the steps involved in pool management that could help enhance the integrity of the emerging system (Ullah et al., 2024).

The literature highlighting issues and challenges in implementing the pool

management and profit distribution framework in realizing the objectives defined in SBP's framework is scarce. Furthermore, no research has evaluated the framework for transparency and standardization of the processes involved in the management of deposit pools and the distribution of profits among various categories based on the size and tenor of the deposits. To this end we extend the ongoing debate to the aspect of equity that is the hallmark of Islamic banking and finance as compared to conventional finance. Building on the existing research gaps in the literature, this study addressed the following objective. It examined whether the practices of Islamic banks in profit distribution are consistent with principles of fairness, particularly in the allocation of profits between depositors and shareholders, as well as across different categories of profit. The next section gives the review of the relevant literature and the theoretical framework of the profit and loss sharing mechanism pool creation, pool management, Hiba distribution and the weightage system in the context of Islamic banking. This is followed by a description of the research methodology; particularly, we discuss the qualitative and quantitative methods along with data description and statistical techniques. The subsequent section present findings based on qualitative and quantitative methods. Final section offers conclusions, and policy recommendations of the study.

LITERATURE REVIEW

The literature on deposit management and profit distribution by Islamic banks integrates the classical discussions in fiqh al Muʿāmalāt with the contemporary discourse on using Mudārabah as a mode for mobilizing deposits for the business operations by the Islamic banks and financial institutions. Bahrain based standard setting institution, AAOIFI[1], has rendered a valuable service in providing following Shariah Standards (SS) for the objective in a Shariah compliant manner: I) SS 13 on Mudārabah is the most important as the basis of relationship between the investors and the banks as Mudāribs, ii) SS 28 provides rules for banking services (deposit taking) as per Islamic law also covering the wakalah (fee based), and Qard based deposits on which depositors practically cannot earn any return, and iii) SS 40 on profit distribution in Mudārabah based investment accounts. For the purpose of this study the theoretical framework is based mainly on SS 13 and 40.

Investment accounts for earning potential profits are taken on the basis of unrestricted Muḍārabah, allowing banks to commingle funds and invest across a diversified portfolio without seeking specific consent for each transaction (AAOIFI, SS 13; SS 40). Restricted Muḍārabah (Muḍārabah muqayyadah) is less common in commercial banking and typically employed by asset managers and non-bank financial institutions. Profits are shared as per the agreed PSR as net pool income after the direct expenses and write-offs are deducted from the expenses. According to clause 2/1/1 of SS. 40 depositors have to bear the business loss, if any, on business by the bank as Mudārib except in the case of negligence by the bank.

IBIs in Pakistan are using Mudārabah as the major mode to raise investment deposits from individuals as well as the corporate sector (Ahmad et al., 2024). But the rules of Mudārabah are not being followed in letter and spirit. The main issue is to give arbitrary

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Hiba (gift) to priority depositors. Depositors give investment deposits managed by banks that do business and share the income with the depositors as provided in AAOIFI's Shariah Standard (SS) 40. Mudārabah as per Islamic law is said to lead to equity and justice between the providers of funds and those who use them for the business (Ahmad et al., 2024).

The subject matter of a Mudārabah contract is the profit and the profit-sharing ratio (PSR). If there is a lack of knowledge as to the subject matter, or the PSR, the contract is nullified (AAOIFI, 2015). Similarly, if one party, the depositor or the bank, stipulates a lump sum amount for itself, it precludes the sharing of profit, and the other may be deprived wrongfully. Further, profit is an addition to the capital of the Mudārabah venture (pool); thus, an addition cannot be realized unless the capital or the source of the profit is maintained (Abasimel, 2023).

There are two tools of deposit management and Profit distribution by banks based on the Mudārabah principle ([2]CII, 1980). These are daily averages and the weightages assigned to different categories of deposits. AAOIFI (2015) has also suggested a scoring method for the distribution of profit between the bank and investors. According to AAOIFI's SS 40, the scoring is the most equitable method of accounting for assigning profit shares commensurate with the amounts and their periods of stay in the accounts. This scoring is made through sharing ratios (PSR), daily balances of deposits considering withdrawals and deposits during a period – a month, quarter, or annual.

There must be a defined and transparent formula as well as agreed-upon factors for assigning weightages to ensure that the weightage system is not misused by the banks, thus doing injustice and leading to inefficiency in the financial system (Talang, 2025). Some researchers have suggested in this perspective that while different weightages may be allowed based on the tenor/time of the deposit accounts, differentiation may not be allowed regarding the size of accounts as in that case poor and the small depositors will be getting much lower returns as compared to the big/high net worth depositors of the same tenor/time accounts (Nizam, 2025; Ullah et al., 2024).

It is argued, on the other hand, that the bigger the size and duration of deposits, the higher is its contribution to the actual profit of a deposit pool. Hence, deposits like 'savings account' are assigned lower weightages, since a portion of such deposits is kept idle to meet the liquidity requirements of the bank and the numerous withdrawals allowed in this type of account (Alshammari, 2025). In addition to this, the profit of 'savings accounts' is usually distributed at each profit distribution period, as opposed to the other long-term deposits, which may keep both the principal and profit in the common pool until the deposit matures. Hence, the procedure of assigning weightages has been approved by the CII as well as the AAOIFI.

Based on the above conceptual bases, theoretical framework of this study is conceptualized on three pillars (as shown in Table 2) interrelated to each other namely, (1) the contract for risk-reward sharing, (2) ex-ante PSR agreement out of the net profit after subtracting the direct costs based on the system of equity and justice, and (3) a clear agreed operational mechanism comprising, options like daily products, weightages to be assigned, withdrawals and pool segmentation, and different reserves aimed at stability of the system

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and risk management based on risk profile of the depositors.

The SBP (2012) provided a comprehensive profit distribution and pool management framework to improve transparency and bring standardization in the IBIs' practices while taking care of the stability of the system. That was a step taken in the right direction to replace the discriminate Hibah with a well-thought-out profit distribution and allocation procedure, along with provisions for specific reserves necessary for the sustainability of the system.

However, the banks maneuver and have continued their practice of giving higher rates of profits to 'priority depositors' (Amin, 2025) by circumventing the rule provided in the deposit management framework. They resort to reverse engineering to attain pre-agreed profits for particular target customers. Risk-sharing formulas are camouflaged through complex and unjust systems, PSRs lack clear logical justifications, and frequently prioritize business considerations rather than strict compliance. A related issue is proliferation of multiple pools or instruments such as Special Mushārakah Certificates (Rafiq, 2025; Ullah et al., 2024). As a result, the apparently Shariah-compliant procedure is devoid of equity, justice and transparency.

TABLE 1: Profit Rates on Islamic and Conventional Remunerative Deposits

Panel A: Profit Rate on Deposits (%) – Dec 2021					
Bank Name	Savings	TD 1 Year	TD 2 Years	TD 3 Years	TD 5 Years
Meezan Bank	4.00	6.11	6.78	6.78	6.78
Bank Islami	5.50	5.25	5.30	5.35	6.08
Dubai Islamic	4.50	5.35	5.85	6.00	6.25
Bank Al Baraka	3.50	7.25	7.30	7.50	8.00
MCB Islamic	4.00	4.42	4.42	4.51	4.53
HBL Islamic	4.04	5.04	–	5.55	6.05
UBL Ameen	3.00	3.20	3.80	3.85	4.35
Bank Alfalah Islamic	2.45	5.41	5.42	5.47	5.54
Average	3.87	5.25	5.55	5.63	5.95
Panel B: Interest Rate on Deposits (%) – Dec 2021 / Jan 2022					
Habib Bank	8.25	10.90	11.00	11.50	13.20
United Bank	7.25	9.11	9.15	9.16	10.06
MCB Bank	8.25	7.55	7.94	8.25	8.91
Allied Bank	8.25	6.25	6.25	6.25	6.25
Bank Alfalah	8.25	9.05	10.09	10.25	10.32
Bank Al Habib	8.25	9.55	9.65	9.75	10.00
Askari Bank	8.25	9.00	9.00	9.25	9.25
JS Bank	8.25	9.00	9.50	9.50	9.75
Average	8.13	8.80	9.07	9.24	9.72

The business risks are transferred to the small or common depositors contravening the basic principles of Muḍārabah, while Maqāṣid relating to equity and justice remain unfulfilled (Ullah et al., 2024). Empirical analysis revels that profit rates offered by Islamic banks and windows remain approximately half those of conventional banks. Table 1 shows that profit rates given by the banks as well as Islamic Divisions of the conventional banks remain approximately half those of conventional banks.

TABLE 2: Theoretical Framework of Deposit Management in Islamic Banking

Pillar	Key Elements	Operationalization
1. Foundational Contract (Muḍārabah)	• Depositor = Rabb-ul-māl (capital) • Bank = muḍārib (entrepreneur) • Losses: 100% depositor (unless bank negligence) • Profit: pre -agreed ratio (PSR) • No ribā, no fixed return	Unrestricted Muḍārabah (Muḍārabah Mṭlaqah) with commingled Funds
2. Profit Distribution Principles	• Gross pool income → PER (smoothing) • Split by PSR → depositor vs. bank • IRR (loss protection) after allocation • Guided by ʿadl (justice) & insāf (equity)	Net income after direct expenses; Reserves – Per IRR [optional per AAOIFI SS 40]
3. Operational Mechanisms	• Daily product method (amount × duration) • Weightage system (by tenor/stability) – debated • Asset composition: AAOIFI ≥51% tangible assets – relaxation by jurists in Pakistan ≥20% • No transfer of pure receivables	Pool management; PER/IRR implementation; compliance with transfer restrictions
4. Outcome & Regulation	• Depositor: variable return, bears losses • Bank: Muḍārib fee + indirect expenses • Rules/Regulators: AAOIFI, SBP (2012, 2024, 2025)	Balance efficiency ↔ compliance with equity and justice

Theoretical framework of deposit management by Islamic banks is shown in Table 2. As related literature on Islamic finance does not offer a comprehensive empirical analysis covering equity, transparency, and conformity of current profit-distribution practices in Pakistan to Shariah principles in substance, this study addresses the gaps by examining the alignment of current practices with Muḍārabah theory and operational integrity of the divine system, and implications for credibility, legitimacy, and transparency in the system adopted by the IBIs in Pakistan.

RESEARCH METHOD

The study uses both qualitative analysis and quantitative analysis to integrate theoretical, methodological, and empirical aspects of profit distribution procedure by the banks in Pakistan. The qualitative method involves questionnaire-based interviews with specialist practically involved in the process. The quantitative methods include mean equality test and variance equality test. The detail discussions on qualitative and quantitative methods are given in the following Sections.

Qualitative Data Collection and Analysis

The research based on a survey of the experts' analysis is considered as descriptive. This type of research aims to explain the opinion of the respondents on a certain point, the current practices regarding profit distribution and pool management of Islamic banks, in our case. Interviews are the most widely used method of qualitative research in the business and social sciences domain (Fiazi, 2024). Accordingly, this research used interviews to gather data from the participants belonging to all categories of professionals involved in Islamic banking practices in Pakistan. Thus, we benefit from the perceptions and experiences of such senior-level research participants. Experiences and perceptions could be different for every individual and might vary in different times and situations (Islam & Hassan, 2024).

The study employed a purposive sampling method to select a targeted cluster of Islamic banking experts. Overall, 20 respondents (Islamic banking professionals) were chosen because of their expertise and involvement in practical Islamic Banking. We adopt purposive sampling which is consistent with the aims of the research as it normally targets a small sample of experts or professionals with appropriate knowledge and expertise (Roodposhti et al., 2025).

Following Sehran and Sultan (2025) and Nizam (2025) the research participants selected for the structured and semi-structured interviews included the Sharīah scholars associated with the IBIs as SB members, such as Sharīah reviewers, auditors, senior-level Islamic banking practitioners, and researchers in Islamic finance. Further, it was to ensure that the research participants had first-hand knowledge of the deposit management system adopted by the IBIs in Pakistan. In particular, the sample frame for the respondents is based on geographical spread, and the selection of respondents is the most relevant experts in Islamic banking for this research. Therefore, this study does not rely solely on qualitative analysis; rather, it complements it with quantitative evidence to provide a more comprehensive assessment of profit distribution practices in Islamic banks in Pakistan. In line with this mixed approach, a theoretical framework is developed by integrating both classical and contemporary perspectives to evaluate issues of fairness and consistency in profit allocation across depositors, shareholders, and different profit categories, drawing on both empirical findings and stakeholder insights.

Quantitative Investigation and Analysis

To evaluate the profit and loss distribution mechanism among the Islamic banking sector in Pakistan, the study employs a set of statistical tests that quantify the performance and distribution of key factors from 2015 to 2024. These variables include the Mudārib share in

profit, Rabb-ul-māl share in profit, percentage, and amount of Hiba distributed among the pools, the total number of pools created by the bank for each year, and the total savings deposits. Further, the data from annual balance sheets of the 20 Islamic banks were collected and examined. Following for testing differences in mean distributions and variation across Islamic banks, both mean-equality tests and variance-equality tests were conducted. These statistical tests are extensively utilized in the literature of economics and Islamic banking. The selection of the variables is based on theory and existing literature. In addition, we used the Islamic bank deposits, share of the Rabb-ul-māl, share of the Mudārib in profit, number of pools created by the Islamic banks, the amount and percentage of Hiba given in the sample period, and the profit rate.

The study employed the equality test of variances for (a) the quantity of investment pools that each Islamic bank has established, and (b) for the proportion in the form of a percentage that each bank distributes. For every case, the null hypothesis proclaims that each bank has equal population variance both in Hiba share and pool, and the alternative hypothesis declares that there is a difference in at least two variances. The variability differs across banks or years if there is a significant result in Levene's test, which can influence mean comparisons. In case of equal variances, it often applied the variance pooled t-test for means. Nevertheless, if that is not the case, then the literature suggests utilizing the unequal variance Welch variant of the t-test (Thaker et al., 2025).

Recent Change by the SBP in the Profit Distribution Mechanism

It is pertinent to discuss the current regulatory developments introduced by the SBP, particularly, in the context of profit distribution. These regulatory developments are mainly applicable to the surfacing practices of IBIs and provide central context for the preceding analysis. SBP has been issuing directions regarding weights, hiba and minimum profit rates (MPR) for different categories of deposits from time to time. A recent change has been made in profit distribution methodology. SBP had advised in 2012 a maximum limit of '3 times' difference between the maximum and minimum weightages assigned to different categories of deposit. But now this cap of 3 times' difference has been removed vide IFPD Circular No. 09 (26 Nov 2024). In terms of IFPD Circular No. 09 dated November 26, 2024, Islamic Banking Institutions (IBIs) are required to pay profit on their PKR saving deposits, excluding those of financial institutions, public sector enterprises (PSEs), and public limited companies, at a minimum of 75% of the weighted average gross yield (WAGY) of all pools maintained by the IBI (Minimum Distribution Rate or MDR). Importantly, non-funded (fee) income is excluded from the WAGY calculation.

The SBP's IFPD Circular Letter No. 01 of 2025, issued on January 21, 2025, clarified that "saving deposits" include all checking accounts, but exclude remunerative current accounts, term deposit receipts (TDRs), and fixed deposits. Additionally, the phrase “excluding fixed assets” from Circular No. 09 was subsequently removed, indicating that fixed assets will now be included in the pool's average gross assets, which artificially lowers the calculated yield, benefiting banks at the expense of depositors, a move considered unjust and contrary to Islamic principles. Foreign currency (FCY) pools are to be included in the WAGY calculation, whereas Open Market Operation (OMO) pools and standing ceiling facilities such as export refinance are excluded. WAGY is to be calculated by

deducting direct expenses, write-offs, loss on investment sales, and provisions from the pool's gross yield. Additionally, premium contributions to the Deposit Protection Corporation (DPC), though meant for depositor protection, are to be proportionately charged to each pool, a practice that contradicts the Mudārabah framework, where business expenses such as premises or protection costs are the Mudārib's (bank's) responsibility, not the investor's.

Besides, it has created another ambiguity, i.e., what categories of assets and which of the depreciation, depreciated value and/or the balance sheet value of the fixed assets like buildings, vehicles, furniture and fixtures, etc. should be considered. SBP guidelines are silent in this regard. Inclusion of fixed asset depreciation for the MDR calculation may further complicate the profit distribution system and make it unjust to all, favoring the shareholders. Further, if the depreciation of fixed assets is included as the denominator, then the non-fund income originating from utilizing fixed assets must also be included in the numerator.

One simple solution was that a formula for MPR/MDR is indicated for all categories of earning deposits, requiring the banks to pay as per that rate to deposits, except 'Current Accounts'. In case of any extraordinary loss to the assets of any pool, banks may be given discretion to prove the losses. The clarification issued via Circular Letter No. 01 of 2025 appears to dilute the intent of safeguarding small depositors from unjust practices. Profit rates declared by Islamic Banking Institutions (IBIs) for June 2025 ranged from 5.00% to 8.25%, with Bank Islami offering 8.7%, Meezan Bank 7.46%, and Faysal Bank 7.00%. The conventional banks, on the other hand, were mandated to provide a minimum return of 9.5% on all profit-bearing accounts. In general, the weightage system should incorporate socio-economic and ethical considerations like the depositor's objective (e.g., Hajj, Umrah, housing, or education) and their profile (e.g., pensioners, widows, orphans, persons with disabilities, or recent reverts to Islam). Moreover, the parameters such as return payout linkages, deposit categories, and market norms, should be considered for weightage allocations to ensure reasonable treatment and arrangement with the objective of Islamic finance defined by social justice.

RESULTS AND DISCUSSION

The objective of this study is to evaluate the profit distribution mechanism adopted by the IBIs in Pakistan in terms of Shariah conformity and the principles of equity, justice, transparency, and efficiency. The research issues included whether the pool management and profit distribution system adopted by the IBIs in Pakistan conforms to the Shariah principles. As such, this paper aims i) to identify the issues and challenges in the pool management and profit distribution framework and process, and suggests a way forward; ii) to examine whether the related practices are transparent and how the disclosures and transparency could be improved; and iii) to investigate that how the system of pool management and profit distribution in IBIs is standardized and streamlined to make it efficient. Within the above areas, a question pertained to whether the procedure of pool creation and assigning weightages is leading to the realization of the higher purpose of Shariah. A central question addressing this paper is whether the system and procedures of pool management and profit distribution have achieved Shariah legitimacy.

Qualitative Findings

The qualitative component of this study draws on structured and semi-structured interviews with 20 purposively selected Shariah experts, scholars, auditors, and senior Islamic banking practitioners in Pakistan. The analysis based on responses of the research participants reveals that the State Bank, as regulator, needs to take steps for realizing the objective of its own framework. The research participants (RPs) contended overwhelmingly that Islamic banks failed so far in realizing the objective. and that they must strictly observe the principles of risk-reward sharing, for avoiding of ribā in substance, and do justice to all depositors. Many practices of the IBIs deviate from true spirit of Mudārabah through manipulated weightage systems, and preferential treatment of high-net-worth depositors at the expense of common or small depositors. Respondents contended that the weightage assignment procedures were leading to unjust distribution of profits and violation of the broader objectives of Maqāṣid al-Shariah.

Regarding standardization, the RPs recommended introducing rational and disclosed criteria for weightage determination, enforcing minimum illiquid asset requirements in pools, and strengthening Shariah governance eliminating conflict of interests in Shariah advisory system, and effective audits. Standardized transparency, technology integration, and public awareness campaigns have also been emphasized to bridge the gap between form and substance of Shariah compliance. Thus, the study recommends fundamental reforms in weightage systems, disclosure practices, and profit distribution mechanisms to align Islamic banking operations more closely with ethical and religious imperatives. The thematic analysis revealed a consensus on several issues including: a) Lacking Shariah compliance in substance, b) Opaque profit calculation procedures with depositors having little understanding of how their returns are calculated, c) Banks have freedom in creating many pools and assigning arbitrary weightages as a tool to benefit large depositors, exacerbating wealth concentration, and d) absence of standardization serving as an obstacle to a fair and transparent system.

Quantitative Analysis and Key Findings

The quantitative analysis examines the transparency and standardization of profit sharing and pool management practices in Islamic banks in Pakistan. We use a series of statistical tools, including mean equality and variance equality tests. Quantitative sub-objectives have been implemented through specific indicators such as disclosure of business sectors, profit shares of Mudārib' and Rabb-ul-māl, distribution of Hiba, number of pools, and consistency in profit rates. Specifically, this section uses mean comparison test to investigate the fairness of the distribution between the Mudārib' (bank) and Rabb-ul-māl(depositor) profit shares, and to examine consistency of pool management practices across years. This dual methodology allows for a more robust and objective assessment of transparency issues in Islamic banking, particularly in the context of Pakistan. Detailed results and their interpretations are discussed in the following sections.

Descriptive Statistics

Table 3 provides the descriptive statistics of key variables used in the analysis. The mean Rabb-ul-māl profit is 4.844 (SD=2.827, range 0.286–14.118) and Mudārib profit is 6.107

(SD=4.687). Notably, Mudārib's average share exceeds Rabb-ul-māl's, suggesting a larger manager share in profit for the sample period. The mean Hiba is observed 24.743 with a large SD (123.147) which indicates some banks grant large loyalty bonuses while others provide none. The average number of investment pools is 7.42 (SD=10.511), showing wide disparity in number of pools created by the Islamic banks in our sample. However, variations in the number of pools entail low standardization and lift transparency concerns in profit distribution practice, potentially affecting Shariah compliance if contract terms and donor preferences for example, Rabb-ul-māl's share vary extensively.

TABLE 3: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Saving deposit	200	65.803	121.289	0.26	1083.99
Profit earned	200	23.705	55.301	0.1	494.31
Profit expensed	200	12.201	26.884	0.04	207.27
Rabb-ul-māl profit	200	4.844	2.827	0.286	14.118
Mudārib profit	200	6.107	4.687	1.035	49.615
Total profit	200	10.946	5.783	2.037	54.85
Hiba amount	200	24.743	123.147	0	1079.668
Pools	200	7.42	10.511	1	81

Correlation Matrix

In Table 4 we present the correlations among Rabb-ul-māl profit, Mudārib' share in profit, Hiba, and other variables used in the analysis. For example, the variable Rabb-ul-māl profit has only a modest positive correlation with accumulated and earned profits. In contrast, Mudārib' profit has a close to zero correlation with them (0.058–0.131).

In addition, Hiba shows essentially no statistically significant correlation with any of the major profit or deposit variables. There is also only a modest correlation between the number of pools: a small positive correlation with Rab-ul-Mal profit (r = 0.133) and a small negative correlation with Hiba (r = 0.090), neither of which indicates a systematic pattern. These low associations suggest that there is a lack of standard linkage between profit shares and pool structure, which undermines transparency and consistency in the distribution of Mudārabah profit in Islamic banks in Pakistan.

Transparency in Profit Sharing between Banks and the Depositors

Although the State Bank regulations require profit distribution according to mutually agreed ratios through pooling of accounts and weightages system (Ullah et al., 2024), yet there are concerns regarding disclosures and transparency, as the weightages that play a crucial role in profit entitlement are not clearly disclosed. As shown in Table 5, this study assessed transparency by examining equality of mean profit shares using paired t-tests for the period 2015 to 2024.

TABLE 4: Correlation Table

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) Saving deposit	1								
(2) Profit earned	0.934	1							
	(0.000)								
(3) Profit expense	0.887	0.982	1						
	(0.000)	(0.000)							
(4)Rabb_ul_māl profit	0.151	0.283	0.348	1					
	(0.032)	(0.000)	(0.000)						
(5) Mudārib profit	0.058	0.092	0.080	0.131	1				
	(0.415)	(0.195)	(0.262)	(0.065)					
(6) Total profit	0.121	0.213	0.235	0.595	0.874	1			
	(0.087)	(0.002)	(0.001)	(0.000)	(0.000)				
(7) Hiba amount	-0.044	-0.007	0.001	0.178	-0.016	0.072	1		
	(0.533)	(0.920)	(0.988)	(0.012)	(0.822)	(0.310)			
(8) Hiba percentage	-0.035	0.067	0.095	0.120	-0.029	0.034	0.204	1	
	(0.624)	(0.344)	(0.183)	(0.091)	(0.683)	(0.630)	(0.004)		
(9) Pools	0.003	-0.016	-0.007	0.133	0.022	0.084	-0.090	-0.170	1
	(0.965)	(0.821)	(0.923)	(0.060)	(0.755)	(0.239)	(0.207)	(0.016)	

*Note: p -values are reported in parentheses. *, *, *** indicate statistical significance at 10%, 5%, and 1% levels, respectively.

TABLE 5: Mean Difference t-test Results for Mudārib and Rabb-ul-māl Shares

Year	Mean Mudārabah	Mean Raab-ul-māl	Mean Difference	p - value
2015	4.650	2.327	2.322	0.018
2016	4.705	3.799	0.906	0.610
2017	5.571	2.424	3.146	0.006
2018	7.428	3.374	4.053	0.008
2019	13.835	7.277	6.558	0.008
2020	14.967	6.796	8.170	0.017
2021	15.589	6.782	8.807	0.015
2022	33.256	17.174	16.082	0.013
2023	62.394	33.631	28.673	0.017
2024	74.652	38.419	36.233	0.017

The table shows that mean Mudārib share remained significantly higher than the depositors' share in all the years except for 2016where although the mean share of Mudārib is higher than the mean share of Rabb-ul-māl but statistically insignificant. The gap widened after 2017, reaching its highest level in 2024 (36.233). The overall t-test results for the full sample (Table 6) confirm a highly significant difference as the average share of banks as Mudārib (23.704) substantially exceeded the Rabb-ul-māl share (12.201).

TABLE 6: Paired t-Test Results for Mudārib and Rabb-ul-māl Share

Variable	Mean	Std Deviation	Std. Error	95%
Mudārib Share	23.704	3.911	55.301	15.993 – 31.42
Rabb-ul-māl Share	12.201	1.901	26.884	8.451 – 15.949
Difference	11.504	2.074	29.336	7.4136 – 15.59
t-statistic	5.545			
Degrees of Freedom	199			
p-value	0.000			

In general, each pool acts as a virtual enterprise with its risk-return profile. SBP guidelines stress that each pool should have clear objectives, strategies, and asset allocations, with documented bases for deposit assignments and weightages. Ahmed and Afzal (2023) describe a pool as a legal structure having distinct risk and reward features, noting that depositor funds may be allocated into single or multiple pools per Shariah contracts. Each pool's income and expenses should be tracked separately for transparent profit sharing. In practice, Mudārabah depositors are assigned to pools based on account type and bank policies. The average number of investment pools per bank generally increased from 3.5 in 2015 to about 10–11 by 2021–2024. The growth was especially pronounced after 2018: from 4.7 pools in 2018 to 7.15 in 2019 and 10.9 in 2021. It implies that Islamic banks are generating more separate investment pools over time, rather than converging on a common number. In the context of standardization, this upward drift along with year-to-year fluctuations implies non-uniform pool practices. It reveals that the pool-management framework is not yet standardized, potentially making difficult the fairness and transparency of profit distribution across Islamic banks in Pakistan.

The data also reveal that while some banks utilize close to hundred pools, others are closely clustered around small numbers (2–7 pools). This discrepancy suggests that instead of adhering to a single norm, each institution has chosen its pooling approach.) This highlights a lack of guidelines for determining weightages assigned in different pools, with each bank setting its parameters, leading to potential variations in effective profit rates even for similar deposit types (Mujaddidi, 2017).

To sum up the quantitative analysis also demonstrates that the framework issued by the State Bank of Pakistan in 2012 with changes made time to time has not realized the objectives of equity, transparency, and standardization. The statistically significant and widening gap between the banks and depositors' profit shares, and the variability in the number of pools, indicate that current practices frequently favor the banks requiring the regulator to take remedial action. The empirical results complement the qualitative insights obtained from the research participants and highlight the need for essential reforms and enhanced regulatory oversight. Such measures are essential to better align operational practices with the core Shariah principles of risk-sharing, justice, and fairness in Islamic banking.

Further, these findings align with the idea of profit smoothening as discussed in the literature highlighting that banks sometimes adjust their payouts to match conventional interest threshold, which decrease the Rabb-ul-māl's return with respect to their asset. It also suggests that there is a compromise in transparency if the Rabb-ul-māl constantly receives lower rates than Mudārib. The findings have critical implications - highlighting that the current practices undermine the ethical foundations of Islamic finance, potentially

eroding depositor trust and the legitimacy of the ethical system of Islamic finance. The gap between the theoretical model of risk-sharing and the operational reality points to a need for fundamental reform.

CONCLUSION

This study aims to provide researchers with insights into how Islamic banking can help achieve the goal of socio-economic justice in the economy by addressing issues and challenges in the implementation of profit sharing mechanisms, bringing transparency and standardization to Islamic banking practices, and ensuring fair distribution of profits among investors. For this purpose, we used mixed methods, where qualitative findings from expert interviews were combined with the quantitative findings derived from statistical tests using bank-level data. The results provided a nuanced understanding of the disclosure, governance, and operational differences in profit-sharing mechanisms adopted under Mudārabah agreements. The study reveals that Islamic banks are significantly lagging behind in achieving the core essence of Shariah objectives while adhering to the regulatory guidelines issued by the State Bank. The expert insights highlighted issues related to limited transparency in pool management. Despite the State Bank's mandate for clear segregation of sources and allocations, the majority of banks fail to ensure adequate disclosures on sectoral financing, Rabb-ul-māl 's share of profits, pool structure, and profit weighting framework. This information gap weakens the ability of depositors to assess how funds are used, thereby undermining depositor confidence.

In addition to that, the quantitative findings support these concerns. The analysis of profit-distribution ratios revealed significant volatility in returns between banks and across years. Depositors' share of profit fell to nearly 40% in some years, while approaching parity in others. The statistical test confirmed that these differences are statistically significant, showing insufficient standardization across the Islamic banking industry.

The examination of profit rates reveals that IBIs further accentuate inequities. The depositor as Rabb-ul-māl received modest returns vis-a vis the banks (Mudārib). The results consistently show an organized advantage for Mudārib. Paired t-tests confirmed statistically significant and positive differences in several years, reflecting that profit-smoothing practices usually maneuver to the Rabb-ul-māl disadvantage.

Moreover, the Islamic banks do not consistently reveal the business sectors financed through Mudārabah deposits. This lack of sectoral transparency reduces Rabb-ul-māl trust and breaches the SBP's vision of transparency, depositor's trust, and most importantly the open reporting. In addition, wide variations in profit-weightage allocations across products were identified through interviews from industry experts, further reflecting inconsistent practices across the Islamic banks in Pakistan.

In summary, the findings highlight the governance gap in Islamic banks in Pakistan. Despite the fact that regulatory compliance exists on paper, the practice of achieving Shariah compliance objectives is lacking. Profit sharing practices lack standardization, transparency remains poor, and depositor equity continues to be compromised by the disparity in returns. These findings underscore the need for regulatory interventions and institutional reforms to ensure that Islamic banking in Pakistan not only adopts the SBP guidelines but also implements the broader Shariah objectives, including transparency, risk

sharing, and fairness, standardization, and protection of depositors.

Based on the findings of the study, the following policy recommendations are suggested to enhance transparency, fairness, and standardization in the profit distribution mechanism among Islamic banks in Pakistan. Islamic banks should be directed to publish detailed information about each investment pool, including its funding sources and especially sectoral allocation. Uniform disclosure standards will improve transparency, enable depositor monitoring, and strengthen regulatory oversight. To address huge differences in Rabb-ul-māl returns, the SBP should design industry-wide guidelines specifying acceptable profit distribution thresholds or minimum depositor thresholds. Furthermore, Islamic banks that deviate from these guidelines should be required to justify their fund allocations.

Given the unfettered benefits to banks, regulators should require Islamic banks to disclose the methodology used to estimate depositors' and bank profit shares. Establishing clear benchmarks for depositor return protection will better uphold Shariah principles of fairness and transparency. Further, the significant variations in number pools create comparability issues and reflect less clarity in profit distribution across banks. Therefore, financial market regulators should introduce best practice guidelines on pool structure, management and ensure consistency across the industry while allowing flexibility for financial product innovation.

Limitations and Future Directions

This study has several limitations that should be considered when interpreting its findings. First, the quantitative analysis relies primarily on publicly available secondary data from annual reports and SBP publications. Limited disclosure by banks limited access to granular information, particularly regarding individual pool allocation, sectoral financing, and internal profit weighting methodology. Future studies should include primary financial data obtained directly from banks to gain deeper insights. Second, the qualitative component was based on expert interviews with Shariah scholars, bankers, and regulators. Future research could include a wider range of depositors and industry participants to gain more diverse opinions. Finally, future research could adopt a comparative approach, examining profit sharing methodologies to benchmark best practices in other countries. Examining the concepts of depositor awareness and transparency will also provide valuable insights for Islamic banks and regulators who seek to align industry operations with both regulatory objectives and the sanctity of Shariah.

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