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Excess Liquidity Management in Islamic Banks: Shariah and Operational Challenges in Pakistan

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Abstract

Purpose: Excess liquidity represents one of the most structurally entrenched challenges in Islamic banking. In Pakistan, the financing to deposit ratio of Islamic banks stands at approximately 39 percent meaning that 61 percent of available deposits are not being deployed productively. This study investigates the reasons why this gap persists, examining the structural, operational, Shariah related, and sectoral dimensions of excess liquidity management in Islamic banks of Pakistan.
Design/Methodology/Approach: This study employs a qualitative interpretivist research design and conducted twenty-five semi-structured interviews with Shariah scholars, Shariah compliance practitioners, and senior non-Shariah banking professionals, including treasury heads and product developers from major Islamic banking institutions in Pakistan. The study analyses the data using Braun and Clarke's (2006) six-phase thematic analysis framework.
Findings: This study finds that Islamic banks in Pakistan are structurally dependent on a narrow set of instruments, primarily Ijarah Sukuk and interbank placements that are insufficient in volume, tenor diversity, and market depth to efficiently absorb surplus liquidity. Second, a critical short-term liquidity gap persists due to the absence of a functioning Islamic money market and short-tenor Sukuk. Third, the systematic exclusion of Pakistan's growing service sector represents both a major driver of excess liquidity and a missed growth opportunity. Fourth, Shariah compliance functions simultaneously as a safeguard and a constraint, with a persistent gap between theoretical structuring and practical execution.
Research Limitations/Implications: This study is limited to Pakistan and uses qualitative data from 25 expert participants. Future research should focus on developing Shariah compliant short tenor instruments and service sector financing models and should examine the regulatory conditions required for establishing a functioning Islamic money market in Pakistan.
Practical Implications: The findings of this study suggested that the State Bank of Pakistan needs to expand Ijarah Sukuk issuance across shorter tenors and facilitate the development of an Islamic money market. Besides this, Islamic banks need to develop more asset-less financing structures for service sector enterprises that represent more than 50 per cent of Pakistan's GDP but are largely unserved by Islamic banks.
Originality/Value: This study provides the first practitioner-grounded qualitative investigation of excess liquidity management challenges in Islamic banks of Pakistan, drawing simultaneously on Shariah scholars, compliance professionals, and treasury practitioners. It identifies service sector exclusion as a previously under-examined structural driver of excess liquidity, and links instrument scarcity, short-term deployment gaps, and Shariah governance constraints within a single integrated analytical framework.

Keywords: Excess liquidity, Islamic banks, Shariah compliant instruments, Sukuk, Interbank market, Service sector financing, Liquidity management.

1. Introduction

The Islamic finance industry has become increasingly important over the past two decades, not just in Muslim majority countries but globally. Islamic banking is increasingly positioned as an alternative to conventional banking in many markets, and its operations are grounded in principles that prohibit Riba (interest), Gharar (excessive uncertainty), and Maysir (speculation). These are not just technical prohibitions; they reflect a

broader ethical framework that shapes how transactions must be structured (Ahmad, Amjad, & Aslam, 2016; Aslam, 2026; Aslam &Haron, 2019; Aslam & Kalim, 2019; Khan & Aslam, 2018; Mahmood et al., 2014).

According to the Islamic Finance Development Report 2025 by LSEG and ICD, global Islamic finance assets reached US$5.98 trillion in 2025, as well as a 21 percent per year increase, marking the industry's 50th anniversary since the founding of the first Islamic commercial bank in 1975. Islamic banking continues to dominate the sector, accounting for 72 percent of total industry assets and operating across 84 markets globally. The global sukuk market surpassed US$1 trillion in outstanding value in 2024, with total sukuk issuance reaching US$254.3 billion, up 11 percent year on year. Based on current trajectories, global Islamic finance assets are projected to reach US$9.7 trillion by 2029, growing at an average annual rate of 10 percent (ICD LSEG Islamic Finance Development Report, 2025).

Liquidity management is a challenge faced by every bank (Aslam, 2022). However, for Islamic banks, this challenge involves an additional layer of complexity: the prohibition of Riba (interest) under Shariah principles. As a result, conventional tools for managing surplus funds, such as Treasury bills, interest-bearing deposits, and overnight interbank lending at interest, are not permissible options. What may appear to be a technical constraint is, in fact, a structural challenge that fundamentally shapes how Islamic banks manage their liquidity. It influences the assets they can hold, the investment opportunities available to them, and their ability to mobilize funds quickly when liquidity needs arise (Aslam, 2018; Sole, 2007; Kammer et al., 2015).

State Bank of Pakistan's reports show that the financing-to-deposit ratio of Islamic banks stands at approximately 39 percent. This indicates that 61 per cent of deposits are not being deployed in financing activities. Some of this gap is intentional, as banks are required to maintain adequate liquidity buffers to meet unexpected funding needs (Ur Rehman et al., 2021). However, a substantial part reflects a genuine shortage of viable Shariah-compliant investment instruments. Conventional banks operating in the same market have access to Treasury Bills (T-Bills), Pakistan Investment Bonds (PIBs), and an active interbank lending market. In contrast, Islamic banks rely heavily on Ijarah Sukuk, which are often limited in issuance volume and predominantly long-term in tenor (Aslam et al., 2021). Their alternatives also include interbank placements, which tend to offer relatively low returns because the limited availability of Shariah-compliant investment opportunities forces multiple Islamic banks to compete for the same placements (State Bank of Pakistan) (SBP,2025).

The consequences go beyond lower returns. Persistent excess liquidity compresses net income margins, weakens the competitive position of Islamic banks against their conventional counterparts, and, as a result, led to the collapse of Turkey based Ihlas Finans in 2001. This demonstration can create institutional vulnerabilities when it combines with other pressures (Aslam & Haron, 2019; Shabbir et al., 2020). Moreover, this situation can distort monetary policy transmission, as a banking sector holding large idle balances transmits policy signals differently from one that is actively engaged in financial intermediation (Aslam & Haron, 2020; Jain et al., 2023). Therefore, the present study investigates the reasons why excess liquidity persists in Pakistani Islamic banks, drawing on qualitative evidence from 25 practitioners.

2. Literature Review

2.1 Excess Liquidity

Surplus liquidity imposes real costs on banks. Holding funds that cannot be deployed at adequate returns means sacrificing the opportunity cost of those funds, which, in a competitive market, translates directly into weak profitability (Aslam et al., 2023; Primus, 2017). The problem is not unique to Islamic banking; it has been documented in emerging markets across Brazil, Russia, India, China, and Sub-Saharan Africa, but the causes differ in conventional banking; excess liquidity usually reflects risk aversion, credit demand shortfalls, or monetary policy conditions. Same as Islamic banks also reflects instrument scarcity in supply side problem that has no equivalent in conventional systems (Aslam & Haron, 2021: Chy, 2024). Khemraj (2010) defines excess liquidity as total bank liquidity minus required bank liquidity, where the required ratio is set by the central bank. Hence, Islamic banks consistently hold substantially more liquidity than required.

2.2 Excess Liquidity Challenges for Islamic Banks

Islamic banks hold approximately 40 per cent more liquidity than their conventional counterparts (Aslam & Haron, 2025). The academic literature generally attributes this challenge to three key factors: the lack of short-term Shariah-compliant financial instruments, the limited availability of Shariah-compliant open market operations, and insufficient central bank support. These factors are closely interconnected and reinforce one another. The absence of short-term instruments limits Islamic banks' ability to efficiently deploy daily or

weekly liquidity surpluses. Similarly, the lack of Shariah-compliant open market operations restricts the central bank's ability to absorb or inject liquidity through mechanisms compatible with Islamic principles (Aslam, Ur-Rehman, & Iqbal, 2021). Furthermore, limited access to central bank facilities, particularly as a lender of last resort, encourages Islamic banks to maintain larger precautionary liquidity buffers. Collectively, these structural constraints contribute to the accumulation of excess liquidity within the Islamic banking sector (Aslam & Haron, 2026).

Haddad, Ammari, and Bouri (2019) studied Islamic and conventional banks in Bahrain from 1991 to 2001 and found consistently higher liquidity ratios in the Islamic institutions. Hassan and Aliyu (2018) stated that the problem is compounded by heavy reliance on demand deposits and short term liabilities funding an asset base. Besides this, Arif and Anees (2012) identify the problem as multi-layered: limited participants in Islamic money markets, slow development of Islamic financial instruments, absence of a permissible interbank market, no liquid secondary market for Islamic instruments, no lender of last resort, and Shariah interpretation differences that create uncertainty about permissible items. Moreover, Ahmad, Ahmad, and Shaharuddin (2022) highlight the Islamic bank structural isolation that tends to get overlooked. They highlighted that Islamic banks do not have a dense interbank network compared to their counterparts, who check liquidity mismatches on a regular basis.

The Islamic interbank market is too thin and too fragmented for that kind of continuous liquidity recycling to work properly. Paul, Bhowmik, Islam, Abdul, and Masud (2013) examined cash-to-deposit ratios and found Islamic banks holding substantially larger cash buffers than conventional peers, noting that IBs' deposits were coming in but not going out at the same rate. Hence, this indicates that IBs have a narrow range of permissible options to park their surplus funds, and many central banks are unwilling to extend interest free liquidity support to Islamic institutions (Abedallat, 2016). Thus, without a secondary market where Islamic instruments can be bought and sold at short notice, maturity management becomes guesswork, and the rational response is to hold more buffer than strictly necessary.

Islamic banks have tried various liquidity management techniques within the interbank like offsetting mutual balances, commodity Murabaha placements, Mudarabah arrangements. Hence, creating transparent, market-rate incentives for overnight Islamic transactions remains difficult. IFSB report in 2008 found that short-duration Mudarabah or commodity Murabaha deals are not well suited to the kind of active money market trading that conventional banks perform. A prominent example in 2001 collapse of Ihlas Finans in Turkey remains a reference point for what happens when liquidity management is inadequate in an Islamic institution (Ali, 2013).

3.3 Excess Liquidity in Middle Eastern Islamic Banks

Arif and Anees (2012) examined Islamic banks in the Middle East and found that, out of a total asset pool of US$13.6 billion, approximately US$6.3 billion, nearly 46%, was held in liquid assets. These assets either generated negligible returns or remained unproductive, limiting the banks' ability to deploy funds efficiently. Furthermore, the Islamic banks examined in the study maintained substantially higher liquidity levels than their conventional counterparts operating in the same markets. This significant difference suggests that excess liquidity in Islamic banking may represent a persistent structural challenge rather than a temporary cyclical phenomenon. Such a constraint can adversely affect profitability and operational efficiency by limiting investment opportunities and reducing the effective utilization of available funds, ultimately undermining the competitiveness of Islamic banks.

2.4 Commodity Murabaha as a Liquidity Management Tool

Commodity Murabaha is the most widely used tool for managing excess liquidity in Islamic banks globally (Ahmad et al., 2019). The basic structure involves an Islamic bank instructing a conventional bank, acting as an agent, to purchase a commodity from a broker at spot price, then sell it to another broker at cost plus markup on a deferred basis. At maturity, the conventional bank pays the Islamic bank its investment plus the agreed markup. It is essentially a short-term placement structured as a commodity trade.

Rafiullah and Khan (2018) noted that Islamic banks in the Middle East, Malaysia, and the West use this mechanism based on Tawarruq extensively for treasury management. Banks gather deposits promising fixed returns through Tawarruq-based structures, then redeploy those funds using the same mechanism. Hence, Sudan and Oman are notable exceptions, having prohibited organised Tawarruq since it entered Islamic banking in 2013 and yet remaining one of the fastest-growing Islamic banking markets, which is worth noting.

2.5 Problems with Commodity Murabaha

The Shariah and policy concerns around commodity Murabaha are substantial. Mokal, Ahmad, and Zulfaka (2024) stated that Tawarruq disconnects the financial system from the real economy; it accumulates debt

without productive activity; it mirrors interest in its economic consequences; it raises systemic risk through complex structures that are hard to regulate; it channels Islamic liquidity to conventional banks for arbitrage; and in practice, customers rarely obtain genuine possession of the commodity, which is a basic Shariah requirement for a valid sale. The markup in these transactions bears no relationship to any real economic value addition and the commodity is not bought for use or consumption and is a conduit for cash transfer. In this regard, reliance on this structure leaves Islamic banking increasingly indistinguishable from the conventional system.

2.6 Consequences of Liquidity Mismanagement

Maturity mismatch is a fundamental source of liquidity risk in Islamic banking, as it is in conventional banking. The practice of funding longer-term assets with short-term deposits is a common feature of commercial banking. However, Islamic banks may have fewer effective instruments and liquidity management mechanisms available to mitigate the resulting risks. Alam, Nurrahman, and Hamidah (2023) highlight that inadequate liquidity risk management can increase funding costs, force banks to sell assets under unfavourable market conditions, and weaken their overall financial position.

Beyond these financial implications, Islamic banks face an additional challenge related to reputation and depositor confidence. Customers who choose Islamic banking often do so because they expect their funds to be managed in accordance with Shariah principles. Any perceived breach of this trust, whether arising from a liquidity crisis, allegations of Shariah non-compliance, adverse media coverage, or persistent rumor's, may trigger deposit withdrawals and undermine depositor confidence. If withdrawals become widespread, the resulting liquidity pressure can intensify, making it more difficult for the bank to restore stability. Therefore, maintaining adequate liquidity and ensuring credible Shariah compliance are essential not only for financial stability but also for preserving the trust on which Islamic banking depends.

3. Research Methodology

This study is qualitative in nature. Managing excess liquidity in Islamic banks is not primarily a quantitative puzzle; why the problem persists despite being well documented, and the practitioners inside Islamic banking institutions encounter when they try to manage it. This kind of understanding requires conversation, not analysis. The paradigm is interpretivist, and the study treats knowledge about this problem as something constructed through professional experience and Shariah reasoning (Blundel, 2007).

This study interviewed twenty-five participants. All participants had at least ten years in Islamic banking. The sample was purposively constructed to cover three groups: Shariah scholars, Shariah compliance practitioners, and senior non-Shariah banking professionals, including treasury heads and product developers. Institutions represented included Allied Bank, Bank of Punjab, UBL, Faysal Bank, HBL, Al Baraka Bank, Bank Al Habib, Sindh Bank, Meezan Bank, and Raqami Digital Bank. Excess liquidity lies at the intersection of Shariah governance and treasury operations, and understanding it requires insights from professionals in both domains. In this study, data saturation is the point at which additional interviews no longer generate new themes or meaningful insights, and it was reached at approximately the twentieth interview. This is consistent with established methodological guidance for qualitative research involving expert interviews (Vasileiou, Barnett, Thorpe, and Young, 2018).

Interviews were semi-structured and lasted between 45 minutes and an hour. A topic guide covered instrument availability, short-term deployment challenges, service sector financing gaps, and Shariah compliance constraints, but it was a scaffold, not a fixed sequence. Conversations went where participants took them, and some of the most analytically significant material came from threads that were not on the original guide. We recorded all interviews with consent and transcribed them verbatim. In addition, we also reviewed the peer journals AAOIFI standards, IFSB publications, classical Fiqh texts, and SBP regulatory documents to know the reasoning behind the rulings and practitioners interpretation about the constraints.

We used the thematic analysis method, having six phases including data immersion, initial coding, theme development, theme review, naming, and write-up. Codes were built inductively from the transcripts (Braun & Clarke's, 2006). All the participants are identified as R1 to R25. Dominant views are reported as such; minority positions are explicitly analysed rather than noted in passing because this study's dissenting voice sometimes identified something the consensus had smoothed over (Creswell & Poth, 2018).

3.1 Profile of Interviewees

The study sample remains balanced across Shariah scholars, practitioners, and non-Shariah banking professionals to ensure coverage of the theoretical, jurisprudential, operational, and regulatory dimensions of excess liquidity management.

Table 1: Profile of Interviewees

Code	Designation	Institution / Affiliation	Category	Experience
R1	Shariah Advisor	Allied Bank	Shariah Scholar	10+ yrs
R2	Shariah Advisor	Bank of Punjab	Shariah Scholar	10+ yrs
R3	Chairman Shariah Board	Allied Bank	Shariah Scholar	10+ yrs
R4	Shariah Board Member	Raqami Digital Bank	Shariah Scholar	10+ yrs
R5	Shariah Advisor	UBL	Shariah Scholar	10+ yrs
R6	Chairman Shariah Board	UBL	Shariah Scholar	10+ yrs
R7	Head of Islamic Banking & Finance	IBA Karachi	Academic / Expert	10+ yrs
R8	Shariah Board Member	Habib Bank Limited	Shariah Scholar	10+ yrs
R9	Shariah Compliance Manager	Faysal Bank	Shariah Practitioner	10+ yrs
R10	Shariah Support Officer (CAD)	Faysal Bank	Shariah Practitioner	10+ yrs
R11	Shariah Support Manager	Al Baraka Bank	Shariah Practitioner	10+ yrs
R12	Shariah Auditor	Sindh Bank	Shariah Practitioner	10+ yrs
R13	Resident Shariah Board Member	Bank Al Habib	Shariah Scholar	10+ yrs
R14	Shariah Compliance Manager	Bank Al Habib	Shariah Practitioner	10+ yrs
R15	Unit Head Commercial & SME Banking	Faysal Bank	Non Shariah Banker	10+ yrs
R16	Senior Islamic Product Manager	Bank of Punjab	Non Shariah Banker	10+ yrs
R17	Unit Head Commercial & SME Banking	Faysal Bank	Non Shariah Banker	10+ yrs
R18	Unit Head Commercial Banking	Bank of Punjab (Taqwa)	Non Shariah Banker	10+ yrs
R19	Shariah Board Secretary	Bank of Punjab (Taqwa)	Shariah Practitioner	10+ yrs
R20	Senior Manager Shariah Compliance	Faysal Bank	Shariah Practitioner	10+ yrs
R21	Divisional Head Pool Management	Allied Bank	Non Shariah Banker	10+ yrs
R22	Head Business Transformation	Faysal Bank	Non Shariah Banker	10+ yrs
R23	Shariah Compliance Manager	Meezan Bank	Shariah Practitioner	10+ yrs

Code	Designation	Institution / Affiliation	Category	Experience
R24	Unit Head Credit Administration	Al Baraka Bank	Non-Shariah Banker	10+ yrs
R25	Regional Head Credit Administration	Al Baraka Bank	Non-Shariah Banker	10+ yrs

5. Thematic Analysis

This study presents findings from 25 semi-structured interviews focused on the challenges Islamic banks face in managing excess liquidity. We produced four themes, each addressing a distinct dimension of why the excess liquidity problem persists. The themes are presented below, with dominant and minority views both given analytical space.

5.1 Theme 1: Structural Dependence on a Narrow Set of Instruments

The most consistent finding across the interviews is that Islamic banks in Pakistan manage excess liquidity through two instruments, such as Sukuk and interbank placements and that this is not a strategic choice but a structural constraint. There is nothing else available (R1, R2, R7).

> "Islamic banks manage excess liquidity mainly through Sukuk and interbank placements; there are no real alternatives available at this time." **(R2)**
> "For long-term liquidity management, Sukuk is the only viable option, while placements are used for short-term needs." **(R7)**

Over Reliance on Sukuk

Sukuk works up to a point. It is Shariah-compliant, government-backed, and generates a return but its availability is limited, and its tenor is predominantly long term. Besides, it does not exist at the short end of the yield curve where Islamic banks need it most. The comparison with conventional banks is stark (R3, R5, R9).

> "Conventional banks have T Bills and PIBs, while Islamic banks only have Sukuk, and even Sukuk issuance is very limited." **(R9)**

This is not a complaint about Sukuk as an instrument. It is a complaint about the absence of a full suite of Shariah-compliant instruments across different maturities and something conventional banks take for granted.

Placements: Necessary but Structurally Weak

Interbank placements fill the gap that Sukuk leaves at the short end, but they carry a fundamental problem: every Islamic bank in the system is simultaneously trying to use them. When all participants have excess liquidity, the placement market offers poor returns and does not meaningfully reduce the surplus (R4, R8).

> "Placements are used only because there is no other option; when every bank has excess liquidity, returns automatically fall." **(R8)**

Synthesis

Islamic banks are not managing excess liquidity poorly, although they have limited financing tools and those tools are insufficient. The structural dependence on Sukuk and placements is a symptom of instrument scarcity, not treasury mismanagement. Therefore, solving it requires new instruments, not better use of existing ones

5.3 Theme 2: The Short-Term Liquidity Gap

Sukuk addresses medium and long term deployment requirements of banks. Interbank placements address some short term needs, but there is a gap between short-term, daily and weekly liquidity management and no adequate tool exists to use for this purpose. This was the most operationally acute concern across the interviews (R2, R11, R17).

> "Short term liquidity is the real problem; Sukuk is not a solution for daily or weekly liquidity needs." **(R11)**

Why Placements Fall Short

The yield problem with placements has already been discussed but there is also Shariah issues need to discuss. Thus, the executing of Musharakah and Mudarabah arrangement for three or four days creates Shariah issue in

documentations and offer and acceptance timing requirements that are difficult to meet properly under time pressure (R4, R6, R18).

> "Placements are not effective because almost every Islamic bank has excess liquidity, so returns automatically decline." **(R18)**
> "Executing Musharakah or Mudarabah for three or four days creates serious Shariah and operational risks." **(R6)**

These are not theoretical concerns. They reflect real operational pressures that IBs treasury departments face daily.

The Missing Islamic Money Market

The root of the short-term problem is the absence of a functioning Islamic money market. Conventional banks have T-bills and money market instruments that can be bought and sold at short notice at market rates. Islamic banks have nothing equivalent. This is not a new observation, but it remains unresolved (R3, R14, R19).

> "There is no proper Islamic money market; without short-term Sukuk, excess liquidity cannot be managed efficiently." **(R14)**

Synthesis

The short-term liquidity gap is where the excess liquidity problem is felt most acutely day to day. Developing short tenor Sukuk and a functioning Islamic money market, with SBP's active participation, is the most direct way to address it. That requires regulatory commitment that has not yet materialised at the necessary scale.

5.4 Theme 3: The Service Sector Exclusion

A theme that emerged strongly and somewhat unexpectedly is the role of the service sector in the excess liquidity problem. Pakistan's economy is increasingly service-oriented. But Islamic banking products are almost entirely asset-based, designed for manufacturing and trading sectors that involve physical goods. The service sector like IT firms, hospitals, schools, logistics companies, payroll heavy organisations needs liquidity instead of assets but Islamic banks have nothing to offer them (R2, R7, R17).

> "Islamic banks have catered to traders and manufacturers, but service-based businesses are completely neglected due to lack of products." **(R17)**

What Service Sector Businesses Actually Need

The point is not subtle, and service businesses do not buy machinery. They pay salaries, cover operational costs, and bridge receivables gaps. Islamic financing built around asset purchase and sale is not designed to meet their liquidity issue (R3, R14).

> "Service sector customers need liquidity for salaries and operations, not machinery or inventory, and Islamic banks have limited solutions for this issue." **(R14)**
> "We had a client who needed funds to pay salaries of 800 employees, but we could not finance them due to the absence of a Shariah-compliant structure." **(R18)**

That last example is worth sitting with a business having 800 employees, which required working capital, but they were turned away by an Islamic bank because it does not have suitable products for them. That is not a Shariah problem, but it is a product development problem.

The Replication Trap

When Islamic banks attempt to serve service sector clients, they tend to fall back on asset-based replication models like Tawarruq, Diminishing Musharakah, and leaseback structures that are poorly fit with service businesses and involve documentation and Shariah risk without solving the actual need of the client (R1, R9).

> "Forcing asset-based structures on service businesses only increases documentation and Shariah risk without solving the real problem." **(R9)**

When these attempts fail or are abandoned, the liquidity stays on the balance sheet as excess.

The Macro Implication

R11 offered the most direct summary of what this means at a systemic level.

> "Excess liquidity exists not because there is no demand, but because there is no product for the demand that actually exists." **(R11)**

The crux of this discussion is that the excess liquidity problem is not a demand problem. It is a supply problem, so failure to build the products that would allow Islamic banks to serve the economy as it exists.

Synthesis

Service sector exclusion is a cause of excess liquidity and a missed growth opportunity. So, developing asset-based Shariah-compliant financing structures for service-based businesses would simultaneously reduce idle liquidity and expand the customer base. The challenge is that such structures do not yet exist in a robust, widely accepted form, which brings us back to the innovation deficit identified across these themes.

6.5 Theme 4: Shariah Compliance as Constraint and Safeguard

Every solution to the excess liquidity problem runs into the same boundary, and it must be Shariah-compliant. This is not negotiable; it is the foundational reason Islamic banking exists as a separate category. Respondents were unanimous about this issue (R2, R5, R9).

> "Shariah compliance is the backbone of Islamic banking; without it, profit is not halal." **(R9)**

The Gap Between Theory and Practice

Shariah compliance is not monolithic; it encompasses two distinct dimensions: theoretical Shariah compliance, which concerns whether contractual structures and terms align with Shariah principles, and practical Shariah compliance, which relates to how these contracts are implemented and executed in practice. Several respondents drew a clear distinction between these two dimensions, emphasizing that compliance at the contractual level does not necessarily guarantee compliance in practice (R6, R12, R20).

> "Islamic banks are theoretically Shariah compliant, but practically they are still struggling." **(R6)**

The specific concerns were practical: delayed offer and acceptance in interbank transactions, documentation gaps, post-settlement profit adjustments that were not anticipated in the contract. These are not hypothetical risks are documented occurrences (R12).

Reputational Stakes

Depositor trust is the only competitive advantage Islamic banks have that conventional banks cannot replicate. If Shariah compliance is compromised or even perceived to be, that advantage can disappear (R1, R15).

> "Depositors place their money in Islamic banks only because of Shariah compliance; once that trust is broken, everything collapses." **(R15)**

Compliance as an Innovation Challenge

Some respondents acknowledged that strict Shariah governance can slow innovation, not because of anything wrong with the principles, but because of how they are applied. Hence, getting a new product through a Shariah board takes time. Therefore, scholars are cautious and approval processes are long as well as single dissenting voice can stall something for months. Hence, none of that is unreasonable; the stakes are real, but it does slow the pace of innovation considerably in banks (R4, R17). The respondents who raised this were careful about how they framed it.

> "The problem is not Shariah compliance; the problem is lack of research within Shariah boundaries." **(R17)**

That distinction matters, and the constraint is real, but the solution is not to lower the compliance standard. It is to invest in research that allows innovation within it.

Synthesis

Shariah compliance is the process that makes Islamic banking meaningful and the thing that makes liquidity management harder in banks. There is no version of solving the excess liquidity problem that does not take it seriously. Hence, there is a version that treats it as a design parameter rather than a veto, and that version requires sustained investment in Shariah-grounded product research that has not yet happened at the necessary scale.

6. Conclusion

This study connects the four themes to managing liquidity issues in Islamic banks. Islamic banks are structurally dependent on Sukuk and placements because no other instruments exist. The short-term liquidity gap persists because there is no Islamic money market and no short-tenor Sukuk. The service sector remains unserved because Islamic banks have not developed the products for it, pushing liquidity back onto the balance sheet rather than into the economy. Hence, all of these persist within a Shariah compliance framework that is

real and non-negotiable, but that has not received the research investment that genuine innovation within it would require.

This study has four findings that stand out. First, the instrument scarcity facing Islamic banks in Pakistan is structural rather than cyclical; it will not resolve itself as the market matures without deliberate intervention to expand the Shariah-compliant instrument supply, particularly for short tenors. Second, the short-term liquidity gap is the most operationally acute dimension of the problem, and closing it requires a functioning Islamic money market with active SBP participation, not adjustments to existing interbank arrangements. Third, the service sector exclusion is simultaneously a cause of excess liquidity and an untapped growth opportunity; developing non-asset-heavy Shariah-compliant financing for service businesses would reduce idle liquidity while expanding the customer base. Fourth, the Shariah compliance constraint is real but not the root cause: the root cause is the absence of serious, sustained research into Shariah-compliant alternatives that would allow Islamic banks to serve the full range of financing needs in the Pakistani economy.

The path forward is clearer than the current pace of progress might suggest. Government issuance of short-tenor Sukuk, the development of an active Islamic money market with support from the State Bank of Pakistan (SBP), and innovative product development tailored to the service sector are all achievable without compromising Shariah principles. Rather, these initiatives require policymakers and financial institutions to approach Shariah principles as a framework for innovation and product design, rather than as a constraint on financial development.

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