

**Address by Mr. Riaz Riazuddin, Deputy Governor (Policy), State Bank of  
Pakistan  
“New Realities, New Opportunities”  
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Excellencies, distinguished Guests, Ladies and Gentlemen!

I am delighted to be here at the World Islamic Banking Conference which has become a strategic platform, bringing industry leaders together for drawing future roadmap of global Islamic finance. I would like to thank the Central Bank of Bahrain and the organizers of this event for providing me an opportunity of addressing this august forum.

The post financial crisis era that is defined by slow economic growth and lower employment levels has left us with an uphill task of revamping the global financial infrastructure. Rising from the exotic derivatives market, the crisis affected all sectors of economies. Excessive risk embedded in financial transactions was overlooked by regulatory and supervisory authorities and was exposed when highly leveraged financial institutions were unable to meet their commitments. Aftershocks from the crisis are still being felt as debates regarding economies going back into recession and timing of governments withdrawing their financial support continue. Policymakers are working towards completely overhauling of the international financial architecture and there are voices for having greater accountability and a proactive role of regulators to ensure stability of the financial system.

Prevalent model of Islamic finance has been around for over three decades, however, it was noticed as serious alternate to conventional system in the aftermath

of global financial crisis. Positive feedback relating to Islamic finance from various jurisdictions during the crisis is recognition of its soundness. The world has been able to see beyond the element of religion and view Islamic finance as a moral/ethical system having linkages with real economic activities and internal shock absorbing ability. Shariah principles prohibit Islamic Financial Institutions from interest, excessive risks and speculative activities and require them to ensure Equity, Justice and Transparency in their transactions. These characteristics play a key role in providing stability to this Shariah compliant system. From its humble origins Islamic finance today exists around the globe catering not only to the financial needs of Muslims but also non Muslim.

I believe globalization of Islamic finance will increase in coming years as it has the capacity to fill in the gaps and resolve issues created by conventional finance. However, in order to harness the true potential of Islamic finance, the industry needs to revisit its prevalent paradigm. The current practices of Islamic finance which can be traced back to 1970s have been keeping close proximity to conventional financial products. While this does not affect the element of Shariah compliance, it blurs the distinction of services offered by Shariah compliant institutions. There is a need for these institutions to move away from the traditional business model and explore new opportunities/markets.

Islamic banks with limited scope in the prevalent model will find it difficult to compete with conventional banks that enjoy economies of scale and are more flexible in catering to diversified needs of the economy. The Islamic banking institutions are desired to expand their scope by offering both commercial and investment banking services to be financed by different streams of deposits i.e. current and profit and loss sharing based deposits. The scope so achieved would be instrumental in increasing viability of Islamic banks, improving financial inclusion, promoting entrepreneurial culture, and significantly enhancing the return to depositors.

I am urged to say that Islamic banks need to reach out to strategic sectors such as agriculture, SMEs and housing especially low cost housing. Given the experience

of commodity crises in the past the world has realized the importance of agriculture. Most of the Muslim countries have agriculture as one of the main sectors contributing towards GDP. Islamic banks need to capitalize on this opportunity and finance agriculture related activities. Similarly SMEs remain of paramount importance for achieving growth objectives not only in developing countries but also in developed world. However, given the challenges such as lack of documentation, and non-availability of collateral have made financial institutions shy away from extending funds to this sector. Islamic financial institutions have an inherent strength of participatory based modes that enables them to finance projects on merit rather mere collateral. Hence they can provide much needed funding to this strategic sector. Similarly most of the Muslim dominated countries have a significant proportion of their population having housing needs. Islamic financial institutions can contribute to the expansion of this sector which will also help these Shariah compliant financial institutions contribute towards real economic growth and diversify their financing mix.

One of the key benefits of promotion of Islamic finance is its potential to contribute significantly in financial inclusion. Islamic Microfinance, a confluence of two industries; Islamic Finance and Microfinance, can not only be an efficient tool for financial inclusion by catering to both voluntary and involuntary financially excluded but also towards poverty reduction. I would urge the industry to make individual as well as collaborative efforts to develop this sector, which would improve their market perception besides enabling them to diversify their clientele.

During the global financial crisis of 2007-08 drying up of liquidity in the financial markets not only highlighted the dire need of effective liquidity management at institutional level but have also depicted the urgency of effective mechanism with supervisory authorities for monitoring and providing facilities of varying nature to financial institutions in stressed situation.

Despite numerous efforts made over years to develop a mechanism for efficiently managing funds, Liquidity Management is still a long standing concern in the global Islamic financial industry at institutional, interbank and central bank levels. The availability of Shariah compliant money market instruments used by Islamic

financial institutions for interbank transactions and liquidity management is quite limited and varies from country to country. Concerted efforts are required to address this issue, and develop desired liquidity instruments and facilities such as Shariah compliant lender of last resort and deposit insurance mechanisms

While the relative resilience of Islamic finance has affirmed its viability, it has also conferred significant responsibility on practitioners to develop a system based on intrinsic values of Shariah. This task is challenging given the changing global financial landscape. The increasing integration of Islamic finance across borders multiplies the need of human capital development for the industry. A recent study on the subject estimated a need for more than 50,000 professionals over the next decade to staff the global Islamic financial services industry. Collaborated efforts are required in this regard to provide a stable stream of skilled human resource that is equipped with necessary financial tools and Shariah knowledge. This will help us in sustaining the growth momentum of the industry.

Pakistan is one of the pioneers and effective players in Islamic finance globally. After the experiment of 1980's, Islamic banking was re-launched in 2001 whereby both conventional and Islamic banks were allowed to operate in parallel. Islamic banking industry constitutes 11 percent of overall banking in terms of assets while it has got 13.1 percent share in terms of overall deposits. Given the strong growth momentum and interest of all stakeholders we believe that this expansionary trend is likely to continue and the industry is well set to increase its market share to 15 percent by 2018.

State Bank of Pakistan (SBP) the country's central bank has been at the forefront of all major initiatives for development of the industry. Promoting Islamic finance as a viable and competitive component of the financial system through enabling legal, regulatory and supervisory environment has remained an important component of SBP's strategic goals. I will briefly mention some of our key initiatives;

- Our Regulatory Framework allows **three types of institutional models** for offering Islamic banking services; (i) Full-fledged Islamic banks (2) Islamic

banking subsidiaries of conventional banks and (3) Stand alone Islamic banking branches of conventional banks. The permission to conventional banks to offer Islamic banking services through stand alone branches enabled us to leverage their vast network across the country to expand the outreach of Islamic finance.

- A **multi-tiered Shariah compliance regime** is in place. The four main components of Shariah compliance framework are: 1) Shariah board at the Central Bank, 2) Shariah board comprising of at least three members at bank's level, 3) mandatory internal Shariah audit, and 4) Shariah inspections by the Central bank. The recently issued Shariah Governance Framework explicitly defines Shariah related roles and responsibilities of all key organs of Islamic banking Institutions including board of directors, executive management and Shariah boards to further strengthen Shariah compliance environment in Islamic banks. State Bank of Pakistan is one among very few central banks that have initiated Shariah Inspections.
- Acknowledging the significance of planning for sustaining the growth momentum of the industry, we have issued our second five-year Strategic Plan for Islamic banking industry (2014-18) through rigorous and meaningful consultation with all key stakeholders.
- Considering the evolutionary stage of the industry, we are continuously engaged in refining and improving the legal and regulatory framework to ensure: its responsiveness to the evolving industry dynamics and its effectiveness in identifying, measuring and mitigating the risks associated with Islamic finance. Our detailed instructions for **Profit & Loss Distribution and Pool Management** to bring standardization, improve transparency and safeguard interests of Investment Account Holders (the savings depositors) is an example of this approach.
- **Limited liquidity management instruments** have been amongst key issues faced by Islamic banks in most jurisdictions including Pakistan. We at the central bank with the help of our Government are working on multiple solutions for effective liquidity management. In this regard our recent

significant achievement is the launch of Shariah compliant Open Market Operations (OMOs).

- As discussed by me earlier, we believe that entering into strategic sectors like SMEs, agriculture, micro finance and low income housing will not only bring positive impact on the sustainability of Islamic banking institutions but will also enable the Islamic banking industry to achieve the desired goal of improving overall socio-economic conditions of the society. In this regard the central bank has not only issued specific guidelines but has also set targets for the industry in the strategic plan to reach out to these sectors. To encourage Islamic microfinance, SBP has allowed establishment of full-fledged Islamic microfinance banks, Islamic microfinance services by full-fledged Islamic banks and Islamic microfinance divisions in conventional microfinance banks.
- The Central Bank has assumed a dual role of a regulator and a facilitator for Islamic banking industry. As facilitator we have been partnering with the industry to improve awareness and understanding of the masses regarding Islamic finance and to build the industry's human resource capacity. While we regularly offer trainings through our in house subsidiary, three Centers of Excellence for Islamic finance Education have been established in leading business schools of the country for ensuring adequate supply of skilled HR and promote Islamic finance research culture.
- SBP has conducted a survey based study "Knowledge, Attitude and Practices of Islamic Banking in Pakistan (KAP)"; the first known initiative of its kind, the study comprehensively analyses the demand for Islamic banking in the country besides identifying gaps on both the demand and supply side. Findings of the study have policy implications and are helping the industry to better understand the market and its needs and to contribute towards minimizing demand supply gaps and enhancing financial inclusion. Taking this opportunity of having audience of national and international scholars I call for cross-country research initiatives that will also help in capacity building by addressing key challenges facing the industry.

- State Bank of Pakistan believes that growth and development of complementary parts of Islamic banking i.e. capital markets, mutual funds and takaful, is essential not only for Islamic banking industry but also for the overall growth and development of the country. In order to ensure harmony in overall financial system of the country both regulators of banking industry and capital markets are coordinating with each other for creating conducive environment for growth of Islamic finance in the country.

**Ladies & Gentlemen:**

I will reiterate that every crisis brings an opportunity; it is on us how we benefit from it. The enhanced emphasis on stability of financial system is the hall mark of the changing financial landscape. Development of Islamic finance industry with its true value proposition has the ability to extend soundness to the overall financial system.

This will require dedication and ownership on part of all stakeholders and will also require close coordination and co-operation across jurisdictions. On behalf of the State Bank of Pakistan I assure full support and commitment for promotion of Islamic finance.

Thank You