

Keynote Address, Governor

State Bank of Pakistan

World Islamic Finance Summit 2011

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It is a pleasure to be here this morning and to have this opportunity of addressing this forum of leading practitioners, Shariah Scholars and academics. The themes selected for this summit are very relevant in the backdrop of prevailing economic scenario and will hopefully help us in identifying key issues and a way forward for the industry.

Islamic finance that started off with some local initiatives catering only to the needs of faith sensitive individuals has now evolved into a vibrant global financial industry over the last four decades attracting both Muslims and non-Muslims clientele. The significant growth of Islamic finance is reflective of its increasing acceptability as a competitive system. The experience of Islamic financial institutions of weathering the recent financial crisis has given further credence to their structures that draw strength from Islamic fundamentals which are very sound and prudent in nature. Rooted in Shariah principles, Islamic financial system's unique characteristic of being asset backed lends it prudence and stability.. If adopted in total and in true spirit, Islamic financial system could save us from the often recurring crisis in financial markets and their negative fallouts on real economy.

Currently Middle East and Asia are the largest Islamic financial markets with countries including USA, U.K, Europe, Korea, Luxembourg, and Singapore being among the list of non-Muslim countries having Islamic financial services. Islamic financial institutions have gone through major transformation while proactively responding to market demands. With a network of more than 600 institutions operative in more than 75 countries and an asset base of over US\$ 1.13 trillion, the industry is steering towards improving its share in global financial markets during next few years. However given 22 percent of the world population being Muslim, 1 percent contribution by Islamic financial institutions towards global financial assets and deposits depicts a significant untapped market.

Ladies & Gentlemen: Pakistan having a large Muslim population of about 180 million remains at the fore front in promoting Islamic finance. The sector has witnessed strong growth during the last decade and now constitutes about 7.5 percent of the country's banking system with an asset base of about Rs

560 billion and a network of about 800 branches of both full-fledged Islamic banks and conventional banks having Islamic banking branches. This growth trend is likely to gather further momentum with increasing awareness level and expansion of Islamic banking branches in second and third tier cities.

The central bank has played a key role in facilitating Islamic banking industry to reach a point of recognition both at the local and international level. State Bank of Pakistan while being a regulator, has also remained committed to being a facilitator for the industry; it is one of the few regulators that have introduced comprehensive legal, regulatory and Shariah compliance framework for Islamic banking industry. State Bank has issued model agreements for encouraging standardization within the industry and in order to ensure that this does not undermine element of innovation banks are allowed flexibility in developing products. In order to bring harmony and to make local industry at par with international industry the central bank is reviewing and customizing AAOIFI Shariah Standards in a gradual manner. Development of Shariah Inspection regime and an enforcement framework for Shariah compliance in Islamic Banking Institutions also exhibit regulator's commitment towards promoting Islamic finance in the country.

Ladies & Gentlemen: The prevalence of significant unbanked population in the country due to probable reasons such as low penetration of the banking system and religion based voluntary exclusion by individuals from interest based banking indicates a potential opportunity for Islamic banks. Given that business in big cities is moving out into second and third tier cities especially rural areas, Islamic banks can take advantage of this opportunity. To facilitate Islamic banks making this move SBP has recently provided a revised definition of rural areas to help Islamic banking industry increase its outreach to second and third tier cities and towns.

The business model of current paradigm of Islamic banking industry both at domestic and international level has a relatively lower mix of participatory modes such as Musharka and Mudarba. Moving closer to these modes will help Islamic banking industry to bring in their fold clientele such as SME that has been ignored by conventional finance industry because of its relatively high risk perception. Given its focus on real economy and ability to carry out profit and loss sharing transactions, Islamic banks can support true entrepreneurship thus providing their services also to the SME sector.

Similarly Islamic banks need to diversify their investment portfolios by increasing their financing in areas such as Agriculture where share of the segment in overall financing by Islamic banking industry remains below 3 percent. A country like Pakistan where agriculture has the highest contribution in domestic production, Islamic banks can increase their market share by reaching out such segments. Housing finance particularly the low cost housing is another largely untapped area, which the Islamic banks can venture by developing suitable products. Islamic micro finance is another area where Islamic banks can serve people who remain unbanked due to their inability of meeting criteria to be clients of commercial banks. By targeting underserved sectors Islamic banks can not only increase their depth and breadth but also contribute to higher financial inclusion levels in the country.

The global acceptability and recognition of Sukuk in raising Shariah compliant funds is increasing, with both Muslims and non-Muslim eyeing it as an opportunity to attract faith sensitive capital. The Sukuk market has a multifaceted role as it brings great benefits for issuers that are in need of finance by providing them capital that has a cost linked to real economy. While investors of these instruments can have their investments in real economic assets representing their share in them, with often generating good returns. At the end of 2010 the global Sukuk market was standing at above US\$ 197 billion. The emergence of Sukuk market in the country also received a welcoming response particularly from Islamic banks and DFIs as it provided them an attractive investment avenue. While there have been various Sukuk issuances both sovereign and corporate in the country the portfolio size remains relatively small compared to countries like Malaysia and UAE. The government has identified the country's infrastructure needs in its Medium Term Development Framework. These infrastructural needs come from diverse sectors including energy, transport & communication and socio-economic. Islamic banks can exploit this business opportunity by developing financing structures for such projects.

Ladies & Gentlemen: The Islamic banking industry can grow at even high pace by diversifying their market and product mix and improving their HR capacity and marketing campaign. The exclusive focus and reliance on debt/trade based modes needs to be gradually reduced to allow for development of participatory based products of Musharaka and Mudaraba, which are the hall mark Islamic finance products. To encourage the industry to venture into participatory modes of financing, State bank has constituted a task force having representation of Islamic banks, business community, academia and accounting professionals to develop an incentive framework for promotion of such products. This framework will be aimed at encouraging Islamic banks to offer participatory modes while minimizing

issues of moral hazard, adverse selection, information asymmetries and trust deficit between Islamic banking institutions (IBIs) and entrepreneurs.

Innovation is a corner stone in providing solutions for financing needs of Islamic bank clients. This innovation however is not possible without continuous supply of adequate human resource. Despite some improvement in the recent past, the availability of properly qualified and trained Islamic bankers still remains a key challenge being faced by the industry. SBP has taken a number of initiatives to build IBIs HR capacity including introduction of Islamic Banking Certificate Course at NIBAF, introducing field training programs for field staff and collaborating with renowned national educational institutions for introduction of Islamic banking courses in their regular programs. While SBP would continue to support the industry, the IBIs will have to significantly increase their investment in building their HR capacity, which has been one of the key impediments in fast pace growth of the industry.

Marketing is another area that requires attention, Islamic banks need to be proactive in this area and make all out efforts to reach to their prospective clients. Lack of skilled staff has also contributed towards relative weakness of Islamic banks in this area. In this regard, SBP has recently launched an awareness campaign to improve Islamic banking literacy, which is critically important for future growth and development of the industry.

Ladies and Gentleman: Islamic banking has come far from its humble origins and established its identity in these challenging times. Given its strong fundamentals and global attention that it has grabbed, I strongly believe that Islamic banking will experience significant growth in times to come. In the end I would like to congratulate Publicitas and its partners for arranging this propitious event. I hope deliberations over these two days would help us in mapping out a futuristic strategy for sustained development and growth of Islamic finance in the country.

Thank you.

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