3.2. Islamic Banking

*The Islamic Banking Institutions (**IBIs**) continued to outpace the conventional banking in terms of expansion of assets and deposits in CY19. Financing witnessed some deceleration due to prevailing macroeconomic conditions and in line with industry trend. Issuance of energy Sukuk provided an investment opportunity to IBIs, but the scarcity of avenues to appropriately deploy liquidity continued to pose for the IBIs. Strong growth in deposits allowed adequate availability of resources and limited reliance on borrowings to meet the financing needs. With a significant increase in profitability, IBIs were the major driver for increase in overall profitability of the banking sector. Despite increase in NPFs, IBIs remained resilient and solvent.*

Islamic Banking continued to observe strong growth momentum…

The assets of the IBIs[231] witnessed a remarkable expansion during CY19 compared with their conventional counterparts (**Table 3.2.1**). Besides the rise in investments and financing by 15.89 percent and 7.39 percent, respectively, the growth in assets was primarily driven by IBIs 'Lending to other Financial Institutions' that grew by 59.21 percent (or 1.5 times the rise in financing) during CY19. The asset growth was well supported by deposits that increased by 20.39 percent. These developments suggest availability of excess funds with the IBIs during CY19.

Table 3.2.2: Performance of Islamic Banking

	IBIs				Conv. Banks			
	CY16	CY17	CY18	CY19	CY16	CY17	CY18	CY19
	PKR Billion							
Total Assets	1,853	2,272	2,658	3,284	13,978	16,070	17,024	18,708
Investments (net)	490	534	515	597	7,019	8,195	7,399	8,343
Financing (net)	821	1,207	1,511	1,623	4,678	5,306	6,444	6,626
Deposits	1,573	1,885	2,203	2,652	10,225	11,127	12,051	13,301
	Percent Change							
Total Assets	15.09	22.60	17.02	23.52	11.53	14.96	5.94	9.89
Investments (net)	13.45	9.03	(3.59)	15.89	8.84	16.75	(9.71)	12.75
Financing (net)	27.21	47.01	25.20	7.39	12.17	13.42	21.46	2.83
Deposits	14.44	19.81	16.87	20.39	13.42	8.82	8.31	10.37

Source: SBP

Profit and loss sharing based financing products continued to enhance share…

With IBIs' business model gaining further maturity and rising awareness among the stakeholders, the. Musharaka based products continued to gain popularity compared to other Islamic modes.[232] Accordingly, the combined share of Musharakah (Running Musharakah and Diminishing Musharakah) increased to 53.84 percent in overall Islamic financing. These products cater to the varying needs of different segments, thus pose no concentration risk.

Table 3.2.2: Islamic modes of financing

	CY16		CY17		CY18		CY19	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
	amount in PKR billion, share in percent							
Murabaha	137	16.07	163	13.16	213	13.81	214.9	12.94
Salam	37	4.36	35	2.80	36	2.36	43.8	2.64
Istisna	75	8.82	101	8.16	140	9.08	158.5	9.55
Musharaka	133	15.68	272	21.99	306	19.85	329.3	19.83
Ijara	58	6.84	79	6.37	95	6.19	95.5	5.75
Car Ijara	37	4.41	47	3.76	61	3.97	58.3	3.51
Plant and machinery Ijara	11	1.31	14	1.12	20	1.27	25.0	1.51
Equipment Ijara	1	0.13	3	0.25	3	0.18	2.5	0.15
Others Ijara	9	1.01	15	1.25	12	0.78	9.6	0.58
Diminishing Musharaka	294	34.53	380	30.73	513	33.28	564.9	34.01
Other Islamic modes of finance	116	13.67	207	16.72	237	15.38	253.2	15.25
Mudarabah	0	0.01	-	-	-	-	-	-
Qard/Qard-e-Hasan	0	0.02	1	0.06	1	0.04	0.7	0.04
Total	851	100	1,237	100	1,542	100	1,661	100

Source: SBP

Amid challenging macrofinancial conditions, the financing observed slowdown…

The IBI's financing, owing to challenging macrofinancial conditions, decelerated during CY19. The financing growth at 7.39 percent was substantially lower than 25.19 percent expansion witnessed in the previous year- lowest since CY11. However, despite substantial deceleration, the pace of IBIs financing activity remained higher than the expansion of 2.83 percent in case of conventional banks.

…across public and private sectors…

Slowdown in flow of financing was visible both in the public and private sectors **(Chart 3.2.1).** However**,** the private sector financing (**PSF**) decelerated more sharply as the demand subsided.

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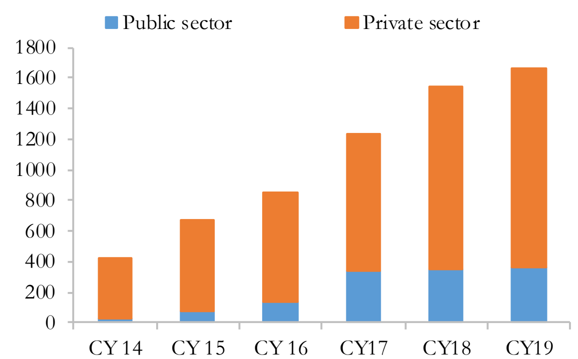
[231] IBIs include both full-fledged Islamic Banks and Islamic banking branches of conventional banks.

[232] IBIs extended financing under three wider modes i.e. Trade based, Leased based and Profit and Loss sharing modes. Within each mode, there were various products to cater to the need of diverse customer base. Also, profit and loss sharing modes include, Musharaka, Diminishing Musharaka and Mudaraba.

The PSF increased by 9.43 percent in CY19 compared with 32.27 percent in CY18, while public sector financing grew by 1.94 percent lower than the 4.31 percent rise in CY18. As a result, there was a meager change in share of financing to public sector, which stood at 21.64 percent in CY19 (22.86 percent in CY18). It is pertinent to mention that most of the financing to the public sector was availed for commodity financing operations and energy sector needs which entails limited credit risk.

Chart 3.2.1: Public and Private sector Islamic financing

(PKR Billion)



Source:

Regarding PSF, IBIs, recognizing the possibility of increased credit risk amid challenging economic conditions, took a cautious approach that caused a slowdown in financing.

…and across various segments, except agriculture.

The financing flow to corporate segment decelerated to 8.57 percent in CY19 from a high growth of 31.01 percent in CY18; a consequence of the prevalent macroeconomic conditions **(Table 3.2.3)**. Despite slowdown, the share of Islamic financing in overall corporate financing had marginally increased to 20.79 percent in CY19 from 20.16 percent in CY18.

Table 3.2.3: Segment-wise Islamic financing

	IBIs				Conv. Banks			
	CY16	CY17	CY18	CY19	CY16	CY17	CY18	CY19
	PKR Billion							
Corporate Sector:	659	874	1,145	1,243	3,117	3,643	4,533	4,736
Fixed Investment	340	426	541	587	1,475	1,719	2,000	2,106
Working Capital	260	361	497	521	960	1,099	1,533	1,612
Trade Finance	59	88	106	135	683	825	1,000	1,018
SMEs:	29	41	57	58	365	401	439	414
Fixed Investment	7	12	23	26	80	85	95	79
Working Capital	20	27	31	29	243	277	299	296
Trade Finance	1	2	3	3	42	38	45	39
Agriculture	7	6	5	7	286	308	317	335
Consumer Finance	90	122	156	165	272	316	368	398
Commodity Financing	47	172	162	168	572	563	702	631
Staff Loans	10	12	15	19	94	103	112	132
Others	9	11	3	1	7	5	1	3
Total	851	1,237	1,542	1,661	4,713	5,339	6,473	6,651

Source: SBP

The financing to SMEs also decelerated to 0.66 percent during CY19—down from 40.64 percent in the previous year. Besides the impact of monetary tightening, IBIs themselves scaled down their consumer financing targets, as reported in their annual financial statements. Consequently, IBIs' share in overall consumer financing portfolio marginally declined to 29.31 percent in CY19 from 29.68 percent in CY18.

On the contrary, financing to agriculture surged by 38.85 percent in CY19 (10.10 percent decline in CY18). Such marked rise in financing to agriculture could be the result of enhanced efforts by SBP and notification of Collateral Management Companies (**CMC**) regulations by SECP which aims to promote warehouse receipt financing.[233]

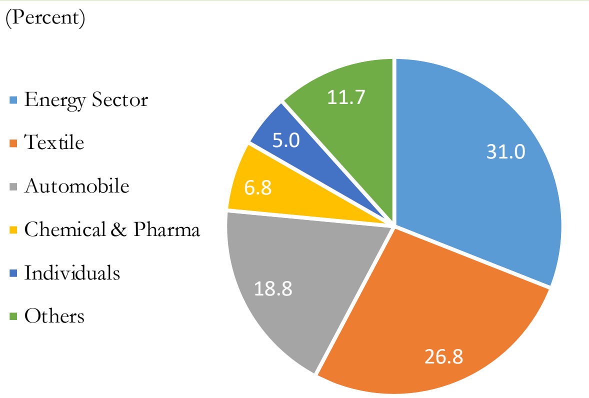
Flow of financing remained diversified…

The sector-wise analysis reveals that although the Islamic financing remained diversified during CY19, energy and textile sectors availed a sizeable proportion of financing **(Chart 3.2.2)**. It is noteworthy that— contrary to previous years— automobile was the biggest sector (after energy and textile) to avail Islamic financing during the reviewed year. An upward revision in the prices of cars' prices due to PKR depreciation and an

[233] Warehouse Receipt Financing (WHRF) is a mechanism whereby farmers, traders and processors may avail financing facility from banks while collateralizing their produce and agricultural commodities as a security stored in accredited warehouses.

increased cost of financing dented demand for new cars. As a result, unsold stocks piled up and cash flows declined. In addition, the car assemblers kept their plants operational, though with reduced intensity. This led to an increase in borrowing by the auto sector. In normal course of business, car assemblers finance their working capital needs from customer prepayments. However owing to reduced demand, they had to avail financing from banks.

Chart 3.2.2: Sector-wise flow of financing

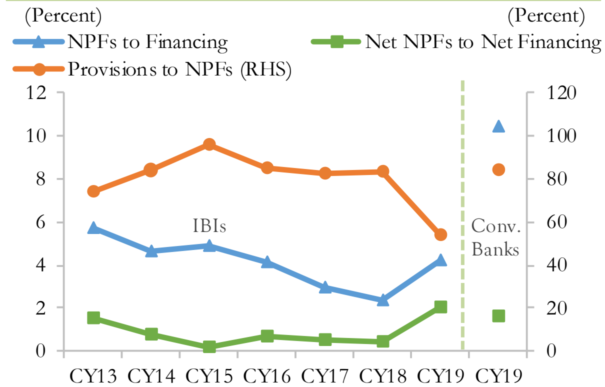


Source: SBP

Asset quality emerged as a critical concern …

The IBIs asset quality deteriorated during CY19. The Non-Performing Financing (**NPFs**) increased by 90.49 percent in CY19 from PKR 37.1 billion in CY18 to reach PKR 70.7 billion. Accordingly, the Non-Performing Financing Ratio (NPFR) of IBIs almost doubled to 4.26 percent during CY19 from 2.41 percent in CY18; however, it remained lower than the similar measure for conventional banks which stood at 10.42 percent (**Chart 3.2.3**). The asset quality issues for IBIs were not broad based and primarily emerged from the real estate sector.

Chart 3.2.3: Asset quality indicators of IBIs



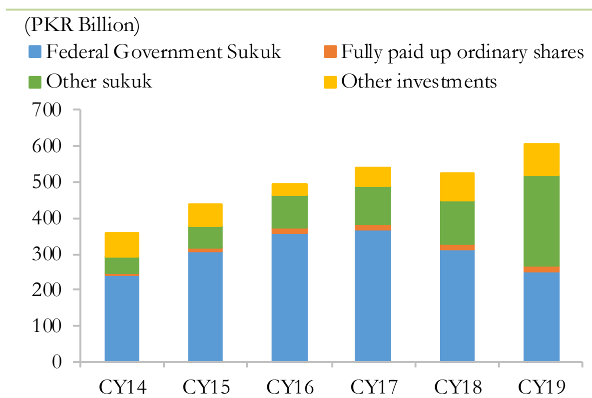
Source: SBP

A hefty, 63.35 percent of the NPFs occurred in the last quarter of CY19, therefore, the provisions coverage ratio dropped sharply to 53.96 percent in CY19 from 83.20 percent in CY18.

Issuance of energy Sukuk led to a rise in investments…

The IBIs' investments surged by 15.89 percent in CY19 as compared to a 3.59 percent decline in CY18. The issuance of PKR 200 billion—first ever energy Sukuk by Power Holding (Private) Limited— during the reviewed year provided an opportunity to IBIs to diversify their asset base. Accordingly, the share of investment in privately placed Sukuk in total investment portfolio increased to 41.42 percent in CY19 from 23.41 percent in CY18 **(Chart 3.2.4)**.

Chart 3.2.4: Breakdown of investments of IBIs



Source: SBP

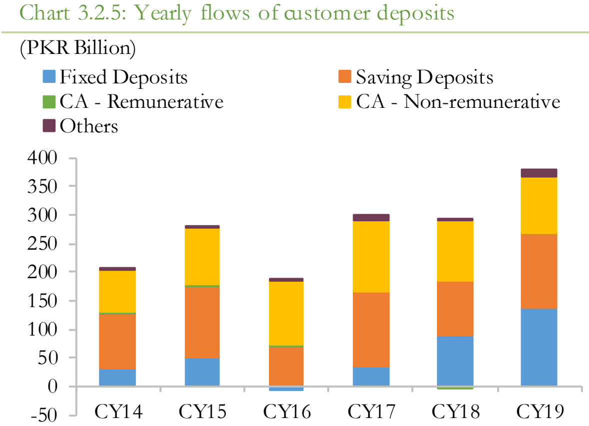
Though the issuance of energy Sukuk a provided long-term investment avenue, the Sharia compliant short-term investment instruments remained scarce for the Islamic banks. Resultantly, IBIs placed their excess liquidity in cash or channeled it to other financial institutions for some earnings primarily under the contract of Bai Muajjal, Musharakah and Commodity Murabaha.

Deposits remained the mainstay of funding…

The IBIs' deposits accelerated by 20.39 percent during CY19—higher than the growth of 16.87 percent in previous year – well above the growth of 10.37 percent achieve by the conventional banks. This was due to offering of competitive products to depositors and extensive marketing efforts. Another reason was the increase in overall branch network from 2,851 branches at the end of CY18 to 3,226 branches as of Dec, 19. As a result of this robust growth, share of IBIs deposits in overall banking sector's deposits rose to 16.62 percent in CY19 (15.45 percent in CY18).

The rise in deposits was broad-based. Fixed and Savings deposits, with 29.41 percent and 15.76 percent growth, respectively contributed the most in the overall growth **(Chart 3.2.5)**. Moreover, current account-non-remunerative category expanded by 13.30 percent in CY19.

Chart 3.2.5: Yearly flows of customer deposits



Source: SBP

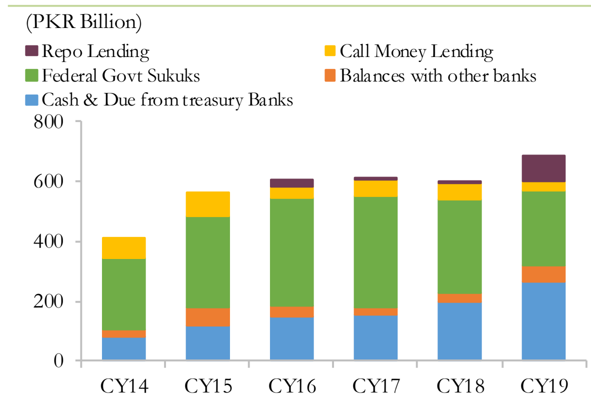
Resultantly, IBIs' dependence on borrowings remained limited…

The IBIs largely financed their funding needs through deposit mobilization, hence remained less dependent on borrowings to expand the asset base. Unlike conventional banks that financed 14.74 percent of their assets from borrowings, IBIs funded only 5.30 percent.

IBIs maintained adequate liquidity, though non-availability of short-term Sharia compliant investment instruments remained a constraint…

Deployment of funds in the short-term Sharia compliant investment instruments continued to be a challenge for IBIs due to lack of availability of such vehicles. To meet liquidity needs, IBIs keep a sizeable portion as idol cash or near cash alternatives. In CY19, IBIs increased their liquid assets by 14.78 percent to meet liquidity requirements. Out of the total liquid assets, 46.53 percent were kept in 'cash' and 'balances with other banks', as compared to 18.42 percent in case of conventional banks **(Chart 3.2.6)**.

Chart 3.2.6: Composition of liquid assets of IBIs



Source: SBP

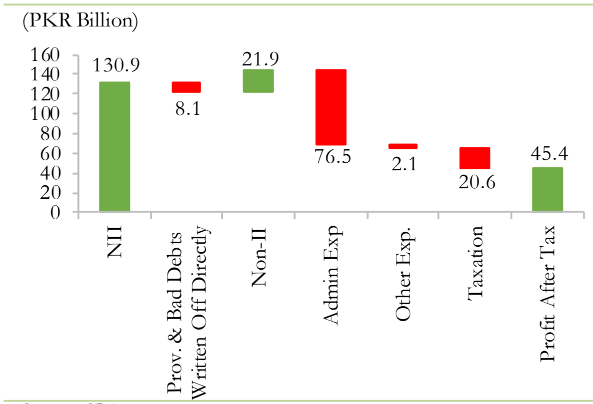
The liquid assets to total assets ratio declined to 20.82 percent in CY19 (22.41 percent in CY18). This was owing to a substantial rise in 'lending to financial institutions' that do not constitute as a liquid asset. The liquidity position of IBIs, however, remained well above the Statutory

Liquidity Requirement (**SLR**) of 14 percent.[234] Further, the financing to deposit ratio (**FDR**) declined to 61.18 percent as of Dec, 19 compared to 68.58 percent in as of Dec, 18. Apart from the decline in demand for financing, issuance of energy Sukuk also diverted the flow of deposits to investments from financing. Despite decrease in FDR of IBIs, it remained higher than the comparable ratio of conventional banks, which was recorded at 49.81 percent at the end of CY19.

And the profitability increased significantly…

The IBIs earnings increased by 82.59 percent (PKR 45.4 billion) in CY19 compared to 51.31 percent in CY18 **(Chart 3.2.7)**. Resultantly, Return on Assets (**ROA**) and Return on Equity (**ROE**) increased to 2.24 percent and 34.45 percent, respectively (after tax ROA was 1.02 percent and after tax ROE was 16.16 percent as of Dec-18).

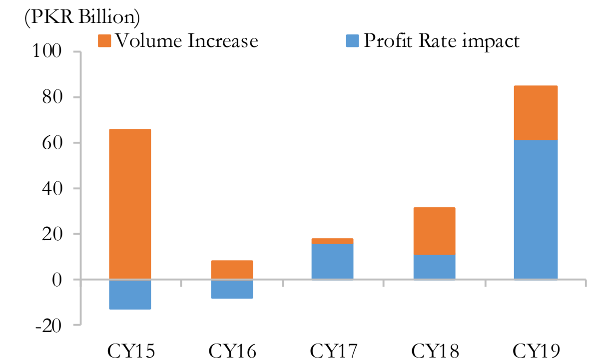
Chart 3.2.7: Net profit for CY19



Source: SBP

The increase in income on financing contributed more than 65 percent in total markup income. The surge in income earned on financing was mainly a result of increase in profit rate though rise in volume of financing also contributed **(Chart 3.2.8)**.

Chart 3.2.8: Impact of rate and volume on income from advances

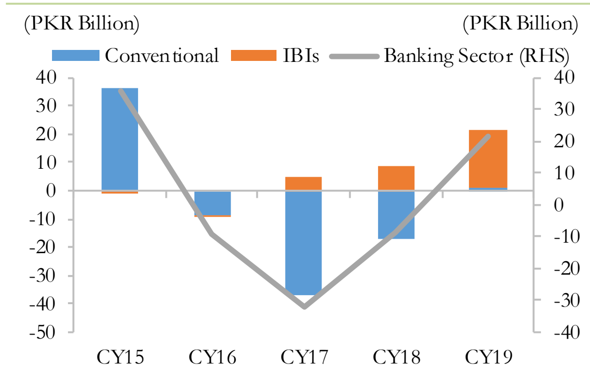


Source: SBP

…which improved the overall profitability of the banking sector…

The profitability of the banking sector increased by 14.34 percent in CY19. IBIs were the major driver behind this increase as they contributed around 96 percent of the rise **(Chart 3.2.9)**.

Chart 3.2.9: Contribution of conventional and Islamic banking in increase/decrease of banking sector profitability



Source: SBP

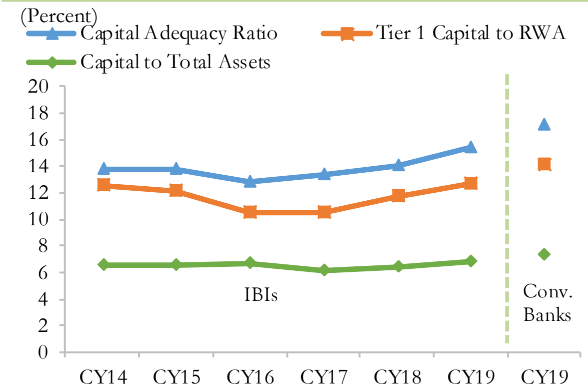
…leading to improved solvency

The Capital Adequacy Ratio (**CAR**) improved to 15.36 percent in CY19 (14.04 percent in CY18), which was well above the regulatory requirement of 12.5 percent **(Chart 3.2.10)**. The improvement resulted from growth in eligible capital as IBIs observed a higher profit retention in CY19. The

[234] The IBIs were required to maintain the liquid assets (excluding statutory Cash Reserve maintained under section 36(1) of the SBP Act, 1956) at 14 percent of their total demand and time deposits with tenor of less than one year in Pakistan. The same SLR requirement was 19 percent for the conventional banks.

CAR of IBIs remained, however, below that of commercial banks due to a high share of financing in total assets.

Chart 3.2.10: Solvency ratios



Source: SBP

Failure to comply with Sharia standards remained a risk…

The IBIs remained exposed to additional risks such as the Sharia non-compliance risk arising from their failure to comply with Sharia requirements and risks arising from additional documentation of the asset-based Islamic financing products. The SBP, continuing its efforts to harmonize the Sharia practices and strengthen the Sharia compliance framework, adapted the five AAOIFI Shariah Standards pertaining to Debit Card, Charge Card and Credit Card; Guarantees; Documentary Credit; Possession (Qabd);Syndicated Financing and Online Financial Dealings during the year under review.[235]

…coupled with lack of trained human resource

In addition, IBIs were facing the challenge of trained human resource scarcity. The banking industry is dominated by conventional banks, thus available experienced resources are well versed with the business model of conventional banking. However, they lack understanding of Sharia laws. One of the reasons behind dearth of desired human resources is the gap between academia and practitioners. There is a need for concerted efforts to bridge the gap between academia and practitioners and introduce a balanced curriculum, covering both sets of competencies.

[235] IBD Circular no. 1 of 2019 available at: http://www.sbp.org.pk/ibd/2019/C1.htm