

IFN Roadshow on Islamic Banking

Keynote Address by Yasin Anwar Governor SBP

First and foremost, I wish to commend the Redmoney group's initiative for organizing this Road show in Pakistan, which is indicative of their continued interest and confidence in Pakistan's Islamic finance sector. I would also like to extend my gratitude to the sponsors of the event i.e. the CIMB Islamic Bank Malaysia, Meezan Bank Pakistan, Pak Qatar Family Takaful Pakistan and Dow Jones Indexes for their support in organizing this event. I also extend a warm welcome to the international speakers and delegates and hope that they would enjoy their stay in Pakistan.

Ladies and gentlemen! Islamic finance initiated modestly about four decades ago to cater to the financial services needs of faith sensitive Muslim population, particularly the high net worth individuals and groups in UAE and Middle East, has now acquired the status of an integral component of the global financial system. The Islamic finance industry has been growing at an exceptionally fast pace and extending its outreach beyond the Muslim countries, which is indicative of its increasing acceptability as a viable and competitive alternative to the conventional system; since 2006 the industry grew on average 28 percent annually with its assets base reaching to US\$822 billion¹. Presently more than 1100 Institutions offering Islamic Financial Services (IIFS) are operative across the globe, which coupled with a number of dedicated academic, legal, regulatory and supervisory institutions provides a solid platform for future growth and development of the Islamic finance industry.

The recent crisis in the western financial markets has also given a big boost to the acceptability and promotion of Islamic banking as a more stable and prudent system than its conventional counterpart. The inherent checks and balances in Islamic financial system, which prohibits Islamic financial institutions to deal in speculative and *Haram* activities (the businesses which are detrimental for welfare of the mankind) and requires them to ensure '**Equity, Justice and Transparency**' in their transactions, largely kept them (the Islamic finance Institutions) insulated from the financial crisis. The frequently recurring crisis in the conventional system, almost four in the last four decades, on the other hand highlights its embedded weaknesses and vulnerability to speculative and self interest maximization behavior. As we witnessed during the financial crisis, even the most sophisticated and modern regulatory and supervisory systems

¹ http://www.kpmg.com/june2010/docs/coming_of_age_june2010.pdf

cannot ensure soundness and stability of a system that have inherent weaknesses. There is thus a need to have a relook at the conventional system to rid it from the embedded weaknesses and avoid the oft recurring crisis in the financial markets and achieve longer term economic stability. The inherent strengths and control mechanism of Islamic financial system could promise the requisite stability provided it achieves greater efficiency, consumer convenience and flexibility, which is the hall mark of the conventional system.

The current Islamic banking paradigm, both in Pakistan and elsewhere, is however, based on replication of conventional banking products. While the replication and mimicking of conventional products to make them Shariah compliant does pass the Shariah permissibility test, it is grossly insufficient to achieve the objectives of Islamic financial system, particularly the broad based and equitable distribution of economic gains. The total reliance of Islamic banks on debt based fixed income products and minimizing the risks to almost close to those of the conventional system is not only blurring the distinction between Islamic and conventional finance but also making Islamic banks relatively less efficient than their conventional counterparts. Thus to sustain the growth momentum, the industry will have to diversify its products mix by focusing on areas where it has comparative advantage rather than blindly following the conventional system, which itself has inherent weaknesses that give rise to the cycles of booms and busts.

In Pakistan for instance 67% of Islamic banks' financing is concentrated in corporate sector through Murabaha, Ijarah, and Diminishing Musharaka. With most of the corporates having banking relationships with conventional banks, the Islamic banks have to offer significant price discounts to attract the corporate clients. This though improves the quality of their financing portfolio, however reduces their profit margins and inhibits their ability to offer better returns to the depositors. It also restricts the access to finance to the well established businesses and corporates and leaves the SMEs and startup businesses financially excluded. This is contrary to the natural business model of Islamic finance, which promotes risk and reward sharing and encourages financing to promising startups that is critically important for promoting entrepreneurial culture. The financing to SMEs and startup ventures through participatory modes like Musharaka gives the SMEs/startups necessary cushion to withstand the teething problems with no fixed interest cost. Although the startups are relatively riskier, however professional appraisal of the venture and capacity of the entrepreneur to manage the venture could

considerably lower the risk of failure, enable Islamic banks to earn handsome returns and allow them to pay better returns to their depositors.

This takes us to another important issue regarding scope of Islamic banks' business. The present scope is confined to that of conventional banks which generally caters to the short term financing needs of the real economy through interest bearing instruments/facilities. While this scope is in line with the business model and deposit streams of conventional banks, it is not sufficient for Islamic banks which were originally conceived for catering to the longer term financing needs of the real economy through risk and reward sharing instruments. As I said earlier, the Islamic banks with this narrow scope will find it difficult to compete with the conventional banks, which are giants when compared with Islamic banks and are highly efficient and flexible in catering to such financing needs of the real economy. The Islamic banks thus will have to expand their scope to offer both commercial and investment banking services to be financed by different streams of deposits i.e. current and PLS deposits for financing the short term trade based activities and restricted investment accounts for financing the longer term investment banking business. The economies of scope so achieved will be instrumental in: a) increasing viability of Islamic banks, b) improving financial inclusion, c) promoting entrepreneurial culture, and d) significantly enhancing the returns to the depositors. I am sure that the speakers and delegates in today's program will thoroughly discuss all these issues and will give recommendations to strengthen the Islamic financial system and to exploit its full potential.

Ladies and Gentlemen! Here I will also briefly discuss Pakistan's Islamic finance industry, its evolution, growth potential and State Bank's plans to help and facilitate development of a robust Islamic banking system.

Islamic banking initiative was re-launched in Pakistan in 2001 as an alternate and parallel system to give option to the public to do banking with the system of their choice that best serves their needs. Learning from the experience of 1980s, a comprehensive legal, regulatory and Shariah compliance framework was put in place before launching the initiative. The framework allows three types of Islamic banking institutions viz. i) Full fledged Islamic banks, ii) Islamic banking subsidiaries of conventional banks and iii) Islamic banking branches (IBBs) of conventional banks. Additionally conventional banks having IBBs can also have Islamic banking windows in their conventional branches. Considering the growing interest of banks in conversion of their

conventional branches into Islamic, we have recently announced the criteria for conversion of the conventional branches into Islamic banking branches.

The initiative has been a big success; the Islamic banking Industry has grown manifold since 2001 and presently constitutes more than 6% of the banking system in Pakistan. Although there has been some deceleration in the growth during last couple of years largely due to slowdown in overall economic activity, the Islamic banking industry is likely to regain the growth momentum and increase its share to 10-12% during next 2-3 years. There are numerous areas/sectors which could be explored to sustain and even accelerate the growth momentum some of which I will like to highlight:

Large un-banked Population- Pakistan with a population of 170-180 million people, 97% Muslim, has a fairly large domestic market, second only to Indonesia. A very large majority of the population is unbanked which is attributable to, among others, low penetration of the banking system² particularly in rural/semi rural areas and general dislike for interest (Riba). A World Bank study on access to finance published in 2008 estimated that only 14 % population in Pakistan is banked and having access to formal financial system. Thus a huge un-tapped market, a significant proportion of which is also faith sensitive, is available for IBIs to offer shariah compliant financial services.

Large Un-served Agriculture Sector- Pakistan being an agrarian economy, agriculture is the strategically important sector for its economy having 20% share in GDP and a major source of livelihood for 65% of the country's population living in rural areas. The sector is also largely un-served/under-served by banks; only less than 20% of about 7 million farm households in the country have access to bank credit³. The Islamic banks can capture a sizeable proportion of this market by reaching out to the growers either directly or through NGOs/MFIs. The IBIs are likely to have better acceptance in rural areas as the rural population is believed to be relatively more faith sensitive. Presently IBIs are largely concentrated in large urban centers; they will have to expand their outreach to smaller towns and rural/semi rural areas and optimally leverage the technology to serve the rural markets.

² One bank branch for more than 17,000 people with branches highly concentrated in 10 big cities

³ SBP Data

SMEs sector is another potential area for Islamic banks to explore. Presently only 0.2 million SMEs are having access to bank financing out of 3.1 million SMEs across the country⁴; the IBIs have just around 2300 SME clients. The low presence of Islamic banks in SMEs is attributable to the high risk perception about SMEs, over conservatism of Islamic banks in under writing the risks and their capacity constraints in serving the non-traditional sectors like SMEs and agriculture. Ladies and gentlemen! The conventional banks could place their surplus funds in risk free government securities, the Islamic banks presently not having this luxury, should develop their capacity to deploy their surplus liquidity in these avenues, which have the potential to be the main drivers of growth for banks including Islamic banks in foreseeable future.

Similarly **Housing finance** is an attractive avenue for Islamic banks; they already have 12% share in the country's housing finance market, which is twice as large as their share in the banking system. Despite a deficit of more than six million housing units in the country, which is increasing unabatedly as the supply is short of demand, the housing finance market is largely under developed; the mortgage loans are approximately 1 percent of GDP, which suggests that a huge un-tapped market awaits banks/IBIs to exploit. The Islamic banks can also have partnership with Federal and Provincial government in developing/building the low cost housing projects, which are on the active agenda of federal and provincial governments.

Ladies and Gentlemen! SBP fully recognizes and appreciates the potential of Islamic banking in increasing the depth and breadth of the banking system and making it more diverse and stable. The system, we believe has the potential to give stiff competition to the conventional system provided it capitalizes on its own inherent strengths and avoids blind faith in conventional system. It is an important component of our strategic goals and we are actively engaged with the industry as the regulator cum partner to catalyze and facilitate development of the industry on sound footings. We have plans to further improve our legal and regulatory framework to allow necessary support and flexibility to the budding industry and enhance its commercial viability. Also there are plans to strengthen the shariah compliance framework to improve the shariah compliance levels in the industry and give comfort to the masses about the shariah permissibility of Islamic banks' operations.

⁴ Federal Bureau of Statistics

We have also launched an awareness campaign to improve Islamic banking literacy, which is critically important for future growth and development of the industry. We are also working with the industry and academia to build HR capacity of the industry, which presently is one of the key challenges faced by the industry. Further, considering the critical importance of risk and reward sharing participatory modes in success of Islamic banking initiatives, SBP is developing an incentive framework to promote the participatory modes. With both the industry and regulator on same wavelength on the future direction of the industry, I am positive that the Islamic banking industry will flourish and strengthen in the months and years to come.

With this let me thank again the Redmoney for taking this initiative and providing us the opportunity to deliberate on the possible strategies to take the industry forward to the next level of growth. Let me also assure full cooperation and ownership of SBP for all such events in future. Thanks.

X...X...X