INAUGURAL ADDRESS OF GOVERNOR, STATE BANK OF PAKISTAN, MR. YASEEN ANWAR AT THE 2ND INTERNATIONAL CONFERENCE ON ISLAMIC BUSINESS AT NIBAF, ISLAMABAD ON FEBRUARY 28, 2012

'Riphah International University deserves to be highly appreciated for its efforts in arranging events that bring together distinguished speakers from around the globe enabling the local audience to benefit from its incisive work in Islamic Finance. I was honored to be invited at the Islamic finance conference last year and am pleased to be here again amongst prominent practitioners, Shariah scholars and academics. I would like to take this opportunity to congratulate the sponsors Islamic Development Bank (IDB), Islamic Institute of Research and Training (IRTI), my colleagues at the State Bank of Pakistan (SBP) and National Institute of Banking & Finance (NIBAF) for making this stimulating event possible. Support and participation visible here demonstrates the commitment and determination of all stakeholders towards ensuring sustainable growth of the Islamic financial industry. The wide range of themes selected for the conference covering prevalent market practices, business opportunities, and social aspects of Islamic finance are interesting for Pakistan as well as for the overall industry.

The Islamic Banking industry in Pakistan has grown at a fast pace maintaining an average growth rate of 30 percent for over the past six years. The industry's asset base has reached Rs. 641 billion which constitutes almost 8 percent of the overall banking industry while deposits representing 8.5 percent of the banking system's deposits. The Islamic banking network has also spread across the country at a significant pace with the total number of branches reaching 886. Given the well sustained growth, the industry is all set to double its market share over the next five years.

Notwithstanding this optimism, the industry is still facing challenges and constraints that need to be addressed to sustain the growth momentum.

Modern Islamic banking has spread over the last four decades and the industry now has systemic importance in the global financial order. The debate has now moved away from the existence and sustainability of Islamic finance to discussions about its penetration levels in various parts of the world. Given its relatively short history, the industry has over US $ I trillion assets with presence in over 75 countries across the globe. This widespread growth has not only been a result of activities of pure Islamic financial institutions but also has contributions of conventional institutions that eyed Islamic finance as a profitable economic opportunity. Moreover, resilience of Islamic financial institutions during the financial crisis has lent them more credence than their interest-based conventional counterparts.

A great deal has been written and talked about in favor of Islamic financial institutions weathering the financial crisis; however I would like to draw your attention to the concerns about these institutions that surfaced during the second round effects of the crisis.

We live in a globalised world where locally centered actions have cross border implications; the Islamic financial industry is not an exception to this. Some have suggested that prohibition on speculative activities kept Islamic financial institutions away from most of derivative based products that created havoc in the financial world, while others viewed asset backed transactions and risk sharing mechanism to be the strength of Islamic financial institutions. While adherence to Islamic principles provides strength to these institutions, they do not shield them from the risks associated with negligence in due diligence, toxic assets or in extreme cases fallout of adverse developments in real the economy. A closer look at the second round impacts of the recent financial crisis shows that Islamic financial institutions did take some hits as a result of the down-turn in property markets (real sector). The inherent risk sharing mechanism though has helped the industry steer through this turbulent period, but economic anxiety during these times has pointed towards the need for better risk management practices and due diligence on part of Islamic financial institutions.

One of the key challenges facing the industry is that of preference of Form over Substance in current practices of the industry. I have discussed this at other forums and would like to emphasize again that Islamic banks at global as well as at the domestic level are working in the shadow of conventional finance i.e. adoption of conventional products that have been tailored to comply with Shariah principles. While the argument of reinventing the wheel is valid to an extent, it takes away the opportunity of offering something unique from Islamic finance. Refinement of routine business and innovation both remain critical as the industry expands. Problems of moral hazard, adverse selection are of serious nature and remain a major hurdle in using participatory modes of financing, however, their absence deprives the industry from attaining one of its desired socio economic goals of ensuring equitable distribution of wealth. State Bank of Pakistan is aware of the issue and is working on a framework in consultation with the industry to encourage participatory mode based financing.

Avenues missed out by conventional financial institutions are a great opportunity for Islamic banks who, given their risk sharing model, can finance projects that are technically viable. In case of Pakistan, Agriculture and SME are sectors of paramount importance in terms of their contribution to GDP, employment generation and overall development of the country; however, these remain largely ignored despite their huge potential and financing appetite. For example, agriculture comprises 21% of GDP and 45% of the work force. Pakistan is also the fifth largest milk producer in the world but does not export any dairy products as New Zealand. This represents huge Sharia compliant opportunities for Islamic banks. Reaching out to such sectors will not only be beneficial for Islamic financial industry but will also guarantee economic welfare of the society. Realizing the significance of Shariah compliant agriculture financing, the State Bank is working rigorously with the industry to develop standardized products and has issued a model Salam based product recently to facilitate financing in this sector.

Over the years the world has realized growth is only beneficial if it is inclusive and access to finance plays a vital role in economic development. Financial exclusion is of two types; Voluntary and Involuntary and Islamic banks can focus on both. Voluntary financial exclusion on the basis of faith sensitivity can be minimized by increasing access and awareness. In Pakistan, SBP is incentivizing and facilitating Islamic banks to expand in 2nd and 3rd tier cities. SBP has revised the definition of rural and underserved areas, according to which any district having less than 10 Islamic Banking Branches (IBBs) will be termed as underserved with respect to Islamic banking facilities. Islamic banks need to be more aggressive in increasing their network to these areas as more than 70 percent of their presence is still concentrated in around 12 cities.

While focusing on involuntary exclusion, Islamic microfinance can be effective in serving the underserved and the deprived population. This side of Islamic finance is in its very early stage even at the global level and requires more effort. In order to encourage existing Islamic banking players and incentivizing new entrants, SBP has not only allowed the establishment of full-fledged Islamic micro-finance banks and permitted full-fledged Islamic banks and Islamic windows to offer Islamic micro-finance services but has also issued guidelines for Islamic microfinance business.

Much discussion about issues confronting the industry revolves around asset liability mismatch due to lack of investment avenues and its adverse impact on portfolio of Islamic banks limited Shariah compliant instruments and avenues make it difficult for Islamic banks to efficiently place their excess liquidity that negatively affects their deposit mobilization ability. To this end, the development of Sukuk has been instrumental; frequent Sukuk issuance in Pakistan since October 2010 has resulted in improving profits of the industry.

However, the absence of a secondary market and Lender of Last Resort facility in many countries, including Pakistan, further creates barriers for Islamic financial institutions in managing their operations effectively.

Acknowledging the dire need of an Islamic Money Market, SBP is focused on developing a comprehensive solution that would provide Islamic interbank money market, Islamic Interbank Offered Rate (IIBOR) as a benchmark for pricing of various Islamic banking products, the development of Shariah Complaint portfolio at SBP to offer as a placement facility to Islamic banks and the provision of lender of last resort facility. This mechanism can also help the government bridge its financing needs.

The growth of any industry is subject to the overall global environment and so the architecture of the Islamic banking industry needs to be agile enough to adjust to ever changing requirements. Investment in human resource, technology and research and development can be key building blocks for such an architecture. We are encouraging Islamic banks to use sophisticated technologies to be more efficient and have provided them leverage for product development.

Shortage of trained and certified experts in Islamic finance is limiting the ability of Islamic banks to expand their outreach. A large majority of the human resource force working in Islamic finance industry comes from the conventional side and hence does not have adequate understanding of Islamic finance which affects their ability in dealing and convincing their current and potential clientele. Given its importance, SBP is helping the industry in developing the desired human resource. We offer regular Islamic Banking courses to domestic and international participants through our training subsidiary NIBAF. We also offer customized training for professionals and experts as well as cross country official visits. We are also collaborating with many international and domestic well-reputed research and training institutes and universities for developing and conducting Islamic banking courses, trainings and degree programmes. We have recently launched a customized proramme for front line managers for their capacity building with special focus on handling client queries. Moreover, for raising awareness, we have also launched a mass awareness campaign and have conducted targeted workshops, public seminars and conferences.

The discussion on the challenges facing the Islamic banking Industry would be incomplete without mentioning issues related to Standardization, Legislation and Governance. While some scholars view difference of opinion as a blessing, lack of standardization has slowed the growth of the industry. If the industry wishes to expand, it is imperative to adopt best practices and ensure high standards of international cooperate governance which will be complemented in this case with Shariah Governance. On the legislation front regulations should be dynamic enough to facilitate the growth of the industry while protecting the interest of all stakeholders and I can assure you that the State Bank of Pakistan remains committed to these objectives.

Despite the issues I have discussed here today, I am optimistic about the future of the Islamic financial industry both globally and in Pakistan. Though these obstacles may slow down the pace of growth, the commitment of all stake holders will help in overcoming these challenges.’