Pakistan – Islamic Finance Industry
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Introduction

1. Islamic finance (IF) is assuming growing significance world wide. Business appeal of IF further stems from its inherent ability to promote economic maximization and social welfare opportunities. This inherent potential of the industry is being unraveled with more distinct recognition of different dimensions and elements of IFs and the financial innovations it offers. It is now increasingly established that

- First, IF promotes equity based financing that epitomizes risk sharing between stakeholders and aligns rewards to be consistent with the risks.
- Second, IF is rooted in an ethical framework and focuses on socially desirable businesses leading to welfare maximization from both economic and social dimensions.
- Third, IF is entrepreneur-friendly and focuses on viability of project as opposed to conventional finance which relies more on collateral and financial worth of the client.
- Fourth, IF appears to be non-inflationary compared to conventional banking which can lead to excessive credit expansion.

2. Demand for Islamic finance is driven by multiple factors: its faith base appeal from one quarter of world's Muslim population, its potential to augment financial engineering blended with socially and ethically responsive financing, its potential to service high net worth clients (whether Muslim or non-Muslim) and its potential to attract cross border oil revenue surpluses. Globally IFIs together is likely to be now a one trillion dollar industry –with the setting up of 250 IFIs that have managed to mobilize $400 billion and remaining from Islamic capital markets across 60 countries including few non Islamic countries.

Pakistan Islamic Industry –Where are we today?

3. Although Pakistan is a late starter to systematically promote IF relative to few other countries, growth in its IF-industry is substantive. Today Pakistan has

- 6 full fledged Islamic banks; 4 operational
- 13 conventional banks with Islamic banking branches
- Over 150 total licensed Islamic banking branches in 25 cities & town
- Rs109 billion **(US$ 1.82 billion)** in assets (2.8%); PKR 79 billion **(US$ 1.32 billion)** in deposits (2.7%) – as of 2nd December, 2006
- 2 licensed Takaful companies
- Half dozen Islamic mutual funds (IsMFs) with total assets of over Rs7 billion **(US$ 0.12 billion)**

- Established Mudaraba Sector

4. The growth in IFI has been remarkable and within three years IBs accounts for 2.9% of the local market share. Excluding Meezan Bank, most of the IBs have only been licensed in 2006. Based on regional experience it takes lead time to nurture this industry. In Malaysia first Islamic Bank commenced operations in 1983 and by March 2006 IFIs market share grew to about 11.6% and Indonesia that launched IF industry around mid 90's, have acquired a share of 1.34% of the total industry.

5. Pakistani-IBs have managed to attract foreign stakes which gives industry an edge and a diverse look with scope for successful cross fertilization and transfer of experiences for the development of the local industry. Rapid growth of IBs has been accompanied by good financial performance and specific industry niche. The capital to risk-weighted ratio has invariably remained significantly above the 8 percent required level, and NPLs ratios have been considerably low.

6. In tandem with the banking sector, non bank financial sector is now emerging with full force. Growth of IsMFs is significant. Since 2003, five Islamic funds have been launched in Pakistan with two funds launched in January 2007. The investments of any Islamic fund are screened for Shariah Compliance based on the criteria approved by the Shariah Advisory Council. The net assets of IsMFs were close to Rs6 billion as of 31 December 2006 albeit the average return for the year 2006 was 1.1%, as compared to the return of 5.06% on Karachi Stock Exchange (KSE). With greater depth, the IsMFs have potential to provide investors with optimum returns in conformity with the precepts of Shariah as well as the flexibility to join or leave the fund at their convenience in an open-end unit structure.

7. On the equity side, besides the presence of IsMFs, Dow Jones-JS Pakistan Islamic Index was launched on 30th August, 2006 to facilitate investment in Shariah compliant stocks. This index would also serve as an underlying index for investment products such as mutual funds, exchange-traded funds etc. The components of the index were weighted by free-float market capitalization, subject to a 10pc cap on the weight of any individual security. Moreover, the index would be reviewed quarterly. Initially 30 companies, which would capture 56pc of the KSE market capitalization, would be represented in the index, but the basic requirement would be that of their Shariah compliance.

8. In Pakistan, first Islamic Term Finance Certificate (TFC) of Rs360 million, a Musharaka-based certificate of 5 years tenor, was issued in June 2002. The Modarabas have been required to seek permission from SECP to issue TFCs under section 120 of the Companies Ordinance, 1984. WAPDA Sukuks were issued for a tenor of 7 years and were allowed to trade in the secondary markets. Pakistan is now establishing Takaful --the Islamic alternative to insurance. Takaful[1] is based on the concept of social solidarity, cooperation and mutual

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[1] To facilitate systematic growth, Takaful Rules, 2005 were introduced under Section 120 of the Insurance Ordinance 2000. Under the rules, Takaful operators are required to invest their available funds in their Participations Takaful Fund (PTF) and Participants Investment Fund (PIF) in the products which adhere to the principles established by the Shariah and all such products shall be approved by the Shariah Board of the Takaful operator. Under the proposed Rules, a Wakalah (agency) operational model has been introduced and under this surplus (if any) in the Takaful fund is distributed to the policyholders. The operator charges Wakalah fee from contributions which covers most of the expenses of the business. The fee is fixed in advance in consultation with the Shariah committee of the company.

indemnification of losses of members. The distinction between conventional insurance and Takaful is embedded in the latter's capacity to integrate Shariah principles, particularly in the areas of risk sharing, investment of funds, participation in management by policyholders, and inclusion of Mudaraba and/or Wakalah principles for management practices. The first Takaful has been set up through international collaboration between leading financial institutions from Pakistan, Kuwait, Malaysia, Saudi Arabia and Sri Lanka. Takaful industry, is however, still in its infancy in Pakistan would require concerted efforts from the Government – in the form of fiscal and other incentives – and the private sector to boost the sector.

9. The introduction of Islamic Pension Funds will further boost market and organizations can offer employees a Shariah compliant avenue for long term investment. Islamic pension funds, together with Takaful corporations, will provide an appetite for medium to long term investment options, thus providing a boost to introduction of long term Sukuk.

The Way Forward - IF Future Strategy

10. Going forward Pakistan- IF industry is evolving and gaining a better understanding of its optimal goals and objectives. SBP has constituted a Task Force with the industry to develop a Strategy for IF-industry. While this work is underway, let me share some of my thoughts which would serve as an input for further both domestic and external deliberations.

11. IBs significance and relevance would magnify in context of Pakistan if the industry were to focus on the unique selling proposition. Realization of these goals would require unconventional thinking and banking as opposed to conventional. In addition, the industry should develop its own niche by focusing on bringing in value addition in outreach and financial innovation by structuring mode of financing which involves more risk bearing and sharing and equity consideration in line with spirit of Quran and Sunnah. With these objectives and goals, strategy should examine how IFIs can be directed to

(i) Enhance the financial penetration ratio across the country and improve access to development finance across sector and regions. IBs are likely to have more appeal for unbanked customers who have shied away from financial world either because of faith or because of lack of access to financial services. The industry has potential to infuse higher degree of sector, industry and product diversification which would create opportunities for a broader layer of society, both in cities and rural areas. The industry could be exploited to offer facilities for SMEs and microfinance to benefit small businesses that embody in their own way the spirit of true entrepreneurship.

(ii) Deepen IFIs conformity with Shariah principles consistent with the spirit of Quran and Sunnah. Goal being eventually to move from simple *"adoption of replicas of conventional products and adapt them to Sharia's compliance to one which is seeking to innovate to structure new products that augment IFIs foundations and operations and align it more with original principles of Sharia."*[2]

(iii) Focusing IBs to exploit equity financing which would augur well for banking sector sustainability that is exclusively loan based and has been facing asset-liability

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mismatches. Efforts may also be made to promote venture capital, given the consistence of its structure with the concept of Musharaka, which makes it an appropriate Islamic financing and investment option.

(iv) Encourage healthy competition between IFIs and conventional banks with a view to rationalize the interest rate and offer competitive pricing to both depositors and borrowers.

(v) Encouraging companies to raise more and more funding through Islamic Mutual Funds, Islamic TFCs and Sukuk paper – foundations of all these instruments is now well grounded. Structuring Islamic REITs transactions -- an asset class which has gained acceptance among global Islamic investors. This will be a new product for Pakistan; targeted measures are therefore required to facilitate the introduction and development of this product in the country.

12. Notwithstanding these features, collaboration between IF and conventional finance is necessary particularly since conventional finance can help IF in the field of asset securitization and syndicated finance. Moreover, it also provides opportunities to use business networks and infrastructure and cross selling of products.

Pakistan Islamic Industry face same debates and challenges that have gripped Islamic Financial Industry world wide

13. First, IBs face an aggressive competition from the conventional banks, given their long standing presence and market share and their predominant role as price setter for deposits as well as loan products. To compete effectively IBs end up align their products and pricing in line with the returns offered by conventional banks. Pakistan IF industry is nonetheless benefiting from spurt of interest world wide in innovating IF and structuring supportive legal, tax and regulatory framework to support. In taking it's IF industry forward Pakistan will benefit from the clarity of some interesting debates and challenges. These debates and their resolution will help strategize Pakistan IF industry. Going forward Pakistan plans to explore avenues and options to

14. ***Develop greater alliance with the international and regional banks to benefit from emerging financial innovation and practices.*** Across the board, there continues a proactive debate on how to structure better Shariah based products. Some question whether there is a real difference between Islamic and conventional products? Others observe that IFI exhibits greater dependence and reliance on Murabaha in Islamic markets which while easy to comprehend and has manageable risk is akin to non-participatory mode of financing and offers profit margins known to both client and bank. Others argue that magnitude of profit is just one aspect of Islamic banking, the Shariah compliant transaction has to fulfill other requirements e.g. existence of underlying real assets, no room for speculation, no misuse of funds for unethical or unproductive purposes.

15. There is no doubt that in its evolutionary stage Islamic product innovation face few constraints and in some jurisdictions there is an attempt to provide a supportive tax, regulatory and rating regime to facilitate the process. IB-industry being in its infancy in developing countries cannot invest in product development due to its costs and only few large banks are

investing in such activities so not a lot of new products are actually added to the existing list. Existence of various schools of thought in Islamic further complicates the product innovation.

16. Independent of these complications and debates, Pakistan plans to draw on International IFIs achievements that have promoted a wide range of activities and products. Leading the change are Sukuk[3] structures--securities issued by institutionally sponsored SPVs with assets backing the transactions. Novel structuring has resulted in floatation of Murabaha and ijara Sukuks – the former offering fixed return and latter a variable return and Sukuk based on Musharaka contracts. Sovereign Sukuks and corporate Sukuks can be benchmarked with the performance of the government and corporates.[4] Heavy weight international banks, including HSBC, Duetsche Bank, Citibank, etc. and investment banks and their research backing is helping explore a wider range of Islamic financial services. Lloyds TSB Bank is offering Islamic Mortgages (home loans). In parallel, a number of Muslim countries have been innovating, developing and refining IF- instruments, on both the asset and liability sides. Moving from evolutionary stage, institutions are structuring and offering a wide range of financial instruments and exploiting new modes of financing and market. On consumer financing side, Islamic credit card based on tawarruq offers all features of a credit card, easy purchases and repayments through a series of commodity transactions.

17. Dedicated Islamic Investment banks are fast emerging focusing on Shariah compliant investment opportunities in infrastructure and real estate. Simultaneously, there is growing emergence of Islamic insurance and reinsurance (Takaful/re-Takaful), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products.

18. ***While being subject to conventional banking regulation and supervision, Pakistan has already adopted Islamic prudential and supervisory framework to judge their IBs compliance with Shariah and to ensure proper risk management.*** Pakistan industry has been proactive in supporting development of prudential regulations and guidelines which offer opportunity to harmonize and standardize risk management, corporate governance and internal controls within institutions. While implementation of these harmonized standards will be a complex process as there prevail differences in Shariah interpretations and applications across jurisdictions. But it views such standards critical because of, among others, its implications for cross border flows for Islamic trading and businesses and enforceability of a transaction given the issues surrounding recognition of legal rights and liabilities of parties. Harmonization of Shariah interpretations would promote homogeneous Islamic financial products and services and provide greater investor protection. Pakistan also will position itself to conform to accounting and reporting standards as laid out by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and work underway by the IFSB, the International Islamic Financial Market (IIFM) and the International Islamic Rating Agency (IIRA) to create more agreement and awareness to create the Islamic finance compatible infrastructure on reporting, capital adequacy, and risk management standards.

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3 Volumes of this product have grown substantially and in GCC markets it account for over 80% of the new bond issuance.

4 Professor Rodney Wilson: Innovation in the Structuring of Islamic Sukuk Securities, New Horizon, Issue No. 158, June 2006 – Global Perspectives on Islamic Banking and Insurance. A Publication of Islamic Banking and Insurance, London, United Kingdom.

19. ***Pakistan has adopted an interim arrangement for liquidity management but it plans to issue Shariah compliant securities to ensure more effective liquidity management.*** Conventional mode of banking has a host of interest bearing securities of varying returns and duration, but Islamic industry faces challenges for liquidity management because of lack of Shariah compliant instruments. So far, WAPDA Sukuks is the only Statutory Liquidity Requirements (SLR) eligible security for IBs. Recognizing this, SBP prescribed transition arrangement where IBs are subject to a lower SLR equivalent to 8% of their time and demand liabilities (relative to 18% for conventional bank) and 7% of cash reserve ratio. IBs can only investment up to 5% in WAPDA Sukuks. IBs have excess liquidity in their books and it has impacted their competitiveness and restricted their potential for financial intermediation and deepening. To facilitate liquidity management of IBs, SBP Task Force has structured a Bait-ul-Mal Certificate – a hybrid Ijara Sukuk with a Murabaha component. The success of such instruments will, however, depend on development of vibrant security market in which IsMFs and Takaful will also play an active role.

20. ***Pakistan would be exploring avenues for developing Shariah compliant derivative to safeguard Islamic investors from various kinds of risks.*** IF-industry, like the conventional financial industry, needs to evolve a compatible derivatives industry to not only manage price risk, but also use it as a tool of corporate budgeting, altering risk profiles, competitive bid pricing, risk transference, generating revenues, and arbitrage trades. Derivatives have been instrumental in creating an efficient foreign exchange and capital markets and reducing systemic risk.

21. The concept of conventional derivatives and hedging is challenged by the providers and users of IFIs, as it embodies the concept of price setting at a future date, which is not permissible in Islam. On the other hand there are scholars who argue that forward trades are permissible in Islam, if done for a specific quantity, time, weight and date. Thus, challenge to practitioners and scholars of IF is to understand the risks to which a user of IFIs is exposed to, be it a financial institution, depositor, borrower, or a business exposed to foreign exchange and commodity price risks, and devise solutions which are acceptable to all players.

22. Overcoming this challenge is not an easy task due to the various hurdles stemming from the lack of availability of contractual forms, lack of methods of eliminating risk inherent in the derivatives contract i.e. counterparty and operational risks, lack of benchmark data and differences in Shariah opinion on a particular structure of derivatives.[5]

23. ***Pakistan is positioning to adopt IFSBs elaborate framework for Corporate Governance:*** Long before the age of complex legal documentation and financial revolution, Islam prescribed the concept of writing contracts in financial transactions, and advocated that no party of any contract or exchange should be exploited. This legacy provides IFIs the foundation of good corporate governance which can be well blended and integrated to reinforce modern principles and models of corporate governance.

24. Foremost amongst the CG challenges is the need for an IFI to assure its stakeholders that (i) its activities are fully compliant with the requirements of Shariah. Mechanisms must,

[5] Examples of these difficulties can be understood from the different opinions which scholars have on the use of standardized futures contract. When it comes to options, the granting of rights and its exercise is acceptable to all Shariah scholars, but they differ on the charging of fee / premium as being unacceptable to some as being unfair trade practices.

therefore, be in place to safeguard against reputational risk arising out of any uncertainty on Shariah compliance; and (ii) it actively promotes their financial interests. This combination of requirements for Shariah compliance and business performance raises specific agency problems for IFIs and calls for clear understanding of roles and responsibilities of Boards of directors, management and Shariah advisors.

25. The corporate governance framework for IFIs must also take into account the risks and challenges associated with different contractual arrangements and instruments permissible in the Shariah. Mechanism need to be put in place to protect the interests of investment account holders to avoid conflicts of interest of investment account holders and those of shareholders of IFIs. This requires that the Boards of directors of IFIs recognize their fiduciary responsibilities towards investment account holders. In addition, there should be adequate disclosure of relevant information about an IFI's investment objectives and policies, operational guidelines, and other significant financial/non-financial information. Pakistan requires IBs to appoint Shariah Advisors, that conform to fit and proper criteria, to ensure internal corporate governance mechanisms are in place and the institutions is implementing it effectively. Lastly, SBP has now introduced a Shariah compliant Inspection Manual and is developing capacities, both at IB and central bank level to ensure that effective implementation and evaluation of corporate governance standards.

26. ***Need to develop a systematic effort to develop IBs' and SBP's capacity building*.** Recent emergence of IF as a specialized discipline couple with the rapid industry growth has led to shortage of skilled human resources who have adequate knowledge of Shariah and finance. To solve the problem of scarcity of quality HR, National Institute of Banking and Finance (NIBAF), the training arm of SBP, has started certification program for practitioners of IF. SBP is in process of establishing educational facility to promote education and research in various areas of Islamic Banking and Finance to offer higher level certification programs. Similarly, efforts are underway to teem up with International Centre of Education in Islamic Finance (INCEIF) the training arm of Bank Negara Malaysia for furthering the education of Islamic finance in both the countries.

Conclusion

27. Central Bank is committed and is strengthening itself to offer different types of services and support to IF-industry. Aside from laying forward direction of the industry growth and its composition, SBP will be enhancing its capacities and developing initiatives to steer the industry from niche market to mainstream Islamic finance by aligning further its administrative structure and prudential regulation and supervisory framework to Shariah principles.

28. For this purpose we have set up a matrix reporting and interaction mechanism whereby the dedicated Islamic Development Department under the Development Finance Group will interact and develop capacities of regulators in BPRD and inspectors in BID. Central Bank will set up a fund with support of the grant funding from aid agencies to help us further enhance financial sector innovation and develop capacities of our development staff, regulators and inspectors as well of high caliber industry staff. While these domestic initiatives are underway, SBP will work with Islamic Financial Services Board to work towards better understanding and resolution of the broader specific issues facing the industry as a whole. Pakistan would have a unique opportunity to play a significant role in this area as it works more closely with IFSB in coming years.