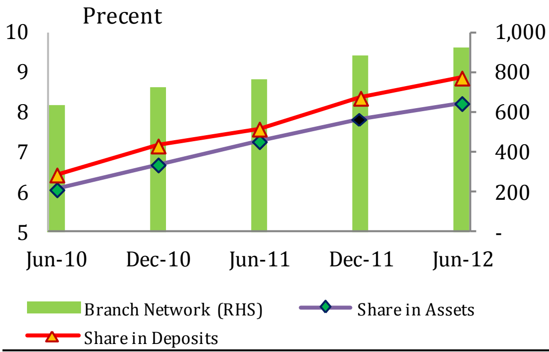
Chapter 4 Islamic Banking

During H1-CY12, Islamic banks continued to make steady progress towards expanding their share in the overall banking industry, thanks to robust growth in deposits. The substantial flow of funds allowed Islamic banks to invest heavily in government sukuks, which tilted the asset mix of IBIs further towards investments and kept IBIs more liquid than the banking sector. However, financing saw a marginal decline as flows to private sector subsided in line with overall industry trend and assets quality deteriorated due to increasing infection in few economic sectors. The IBIs experienced improved profits owing to increasing investment income, non-mark-up income, and decline in provisions; however, RoA saw a marginal dip due to deceleration in financing margins and increasing cost. Solvency ratios improved at the back of rising retained earnings.

Growth pattern of IBIs prevailed

Islamic banking continued its march towards double-digit share in assets and deposits of the banking industry **(Figure 4.1)**. Over the years, IBIs continued growing at twice the pace of conventional banks, which increased their share in total assets of the banking system by 54 bps to 8.2 percent during H1-CY12. An accelerated growth in deposits provided the major support for augmenting the asset base. The substantial flow of funds allowed Islamic banks to invest heavily in government sukuks, which further improved the liquidity indicators. The IBIs' advances declined in line with prevailing risk aversion, while asset quality deteriorated further. The operating performance of IBIs remained moderate, which further improved their solvency. With addition of 62 branches during the half year, the network of IBIs approached 1000 branches.

Figure 4.1
Share and Network of Islamic Banking



Share of Investments surged to almost half of the total assets

The limited appetite of the banking industry for risky assets, muted demand for credit from the private sector in the low growth environment and sufficient supply of government bonds due to high financing needs of the exchequer, increased the exposure of the overall industry to risk free government securities. The IBIs approach was not much different as they channeled most of the fresh funds into Government Ijara Sukuk, which surged the share of investment to almost 50 percent of their total assets **(Table 4.1).**

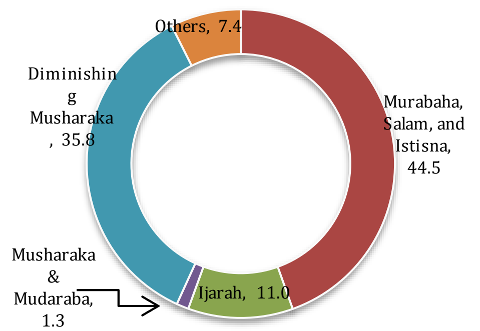
Table 4.1: Growth of Islamic Banking.

	Dec-09	Dec-10	Jun-11	Dec-11	Jun-12	All Banks Jun-12
						Rs. billion
Total Assets	366.3	477.0	560.5	641.0	711.2	8,652.9
Investments (net)	72.2	157.8	231.3	274.3	345.7	3,275.5
Financing (net)	153.5	180.4	188.6	200.2	196.8	3,572.8
Deposits	282.6	390.1	452.1	521.0	602.5	6,802.9
	precent change					
Total Assets	17.0	16.0	17.5	14.4	10.9	5.9
Investments (net)	34.9	102.3	46.6	18.6	26.0	7.2
Financing (net)	9.4	14.5	4.6	6.2	(1.7)	6.7
Deposits	18.7	18.3	15.9	15.2	15.6	9.0

... while financing subsided as flows to private sector pacified

The lackluster demand for financing from the private sector and overall risk aversion of IBIs led to 1.2 percent decline in financing during H1-CY12 against an increase of 6 percent in H2-CY11. Though dip in financing was broad based, flows remained positive for consumer segment, public sector seasonal financing needs for commodity financing, and Production and transmission of energy.

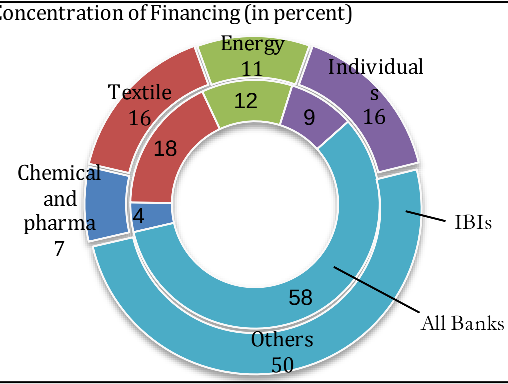
Figure 4.2
Financing Mix (in percent)



Murabaha and Diminishing Musharaka stood out in modes of financing…

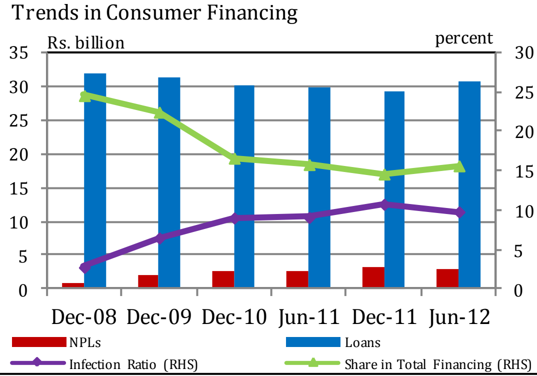
The break-up of financing indicated that the combined share of Murabaha, Musharaka, Salam, Istasna and Diminshing Musharaka accounted for 91.3 percent of financing **(Figure 4.2)**. The increase in Salam and Istasna translated into an increase of Rs 2.0 billion in the commodity finance. End use of financing showed increase in long-term modes of financing primarily in energy sector. Specifically, Murabaha financing declined over the period by Rs6.1 billion mainly because of dip in working capital and trade finance.

Figure 4.3
Concentration of Financing (in percent)



The corporate sector finance represented a major portion of IBIs' gross financing (71 percent) declined during the period under review, mainly on account of decline in working capital/Murabaha based financing. The energy sector where demand for financing observed persistent rise, added another 6.6 percent in its portfolio **(Figure 4.3)**. Segment-wise analysis delineates that agriculture financing remained the most neglected area in overall financing. Despite the fact that SBP has been encouraging IBIs to increase their penetration in smaller towns, rural and semi-rural areas through branch expansion and specifying Shariah compliant agriculture polices for promoting Islamic financing products.

Figure 4.4
Trends in Consumer Financing



Consumer financing continued moderate growth…

Consumer financing has consistently grown over the years and with about 15 percent share in gross financing represent second largest segment in Islamic financing portfolio. Unlike the industry trend, growth pattern in consumer financing continued during the period under review. The IBIs with a 5 percent growth in consumer financing remained the key contributor to private sector financing. Though the growth was broad based, the substantial increase in financing came from Ijarah car financing and Diminishing Musharaka. Interestingly, the credit card portfolio, which still represents meager portfolio, also started to gain ground **(Figure 4.4)**.

Figure 4.5

Customer Deposits

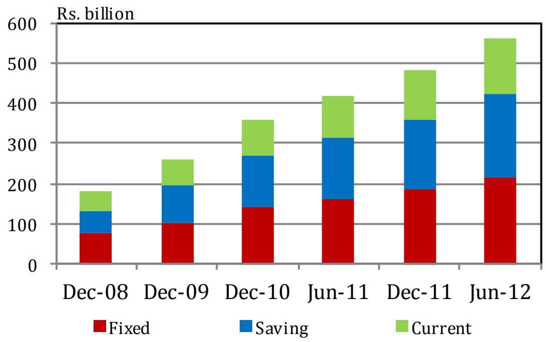


Figure 4.6

Growth in Advances and Deposits (in percent)

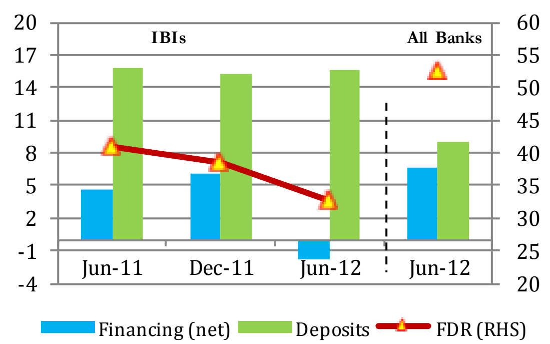


Table 4.2: Asset Quality

				in percent
	IBs			All Banks
	Jun-11	Dec-11	Jun-12	Jun-12
NPF to Financing	7.5	7.6	8.8	15.9
Net NPF to Financing	3.2	2.9	3.8	6.0
Provisions to NPFs	60.0	63.0	59.5	66.3
Net NPFs to Total Capital	11.6	10.5	12.6	26.5
	IBs		IBBs	
	Dec-11	Jun-12	Dec-11	Jun-12
NPF to Financing	9.0	11.5	4.9	4.3
Net NPF to Financing	3.0	4.4	2.9	2.8
Provisions to NPFs	68.9	64.4	42.6	36.9
Net NPFs to Total Capital	10.3	13.7	10.9	10.5
NPFs (billion Rs.)	12.4	15.0	3.5	3.3

IBs=Islamic Banks, IBBs = Islamic Banking Branches, IBIs = IBs+IBBs

Robust growth in deposits provided for most of the funding needs…

The deposit base of the IBIs observed 16 percent growth over the half year, mainly contributed by Modaraba based term and saving deposits and Qurd based current accounts **(Figure 4.5)**. As a result, the share of deposit as a percentage of total asset inched up to 85 percent in H1-CY12 from 81 percent in pervious half **(Figure 4.6)**. The efforts of Islamic banks in expanding their outreach and utilization of the existing branch network by IBBs remained the driving force behind the consistent growth in deposits. However, deposits products being offered by IBIs faced with non-standardized computation of profit and loss and distribution policies. To address the issue, SBP developed a framework[44] for profit & loss distribution and pool management practices, which is expected to improve transparency in sharing of returns on deposits

Liquidity level continues to be in the comfort zone…

Because of sufficient availability of funds and the continued borrowing by the Government, IBIs mainly focused on sukuks as the lending to private sector remained passive. Resultantly, liquidity ratios further improved during H1-CY12 **(Figure 4.7).** Particularly, financing-to-deposit ratio (FDR) of IBIs further dropped to 32.3 percent. Such a low ratio may look good from the liquidity perspective but not desirable as it exhibits declining intermediation, with compromised focus on core-banking activities **(Figure 4.6).**

Though persistent demand from the Government sector allowed IBIs to accumulate substantial amount of Sukuks over the last couple of years, however, they still lack secondary market and the Lender of Last Resort facility to manage additional liquidity cushions. To this end, SBP is working on development of a comprehensive framework for liquidity management covering Islamic interbank market, benchmark Islamic Interbank Offered Rate(IIBOR)and placement of excess liquidity within the central bank.

Asset quality deteriorated…

After seeing an impressive asset quality management for couple of years where the pace of expansion of non-performing

[44] IBD Circular No. 3 dated November 19, 2012

Figure 4.7

Liquidity Ratios (in percent)

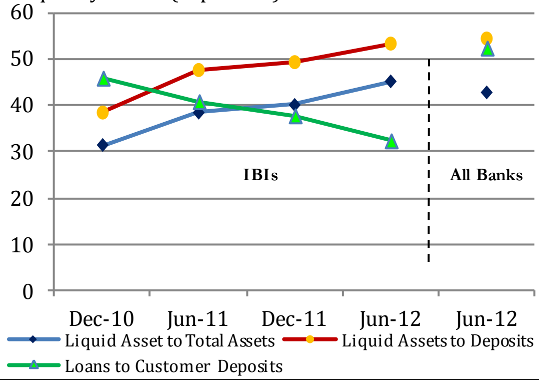


Figure 4.8

IBIs' Earnings and Expenses

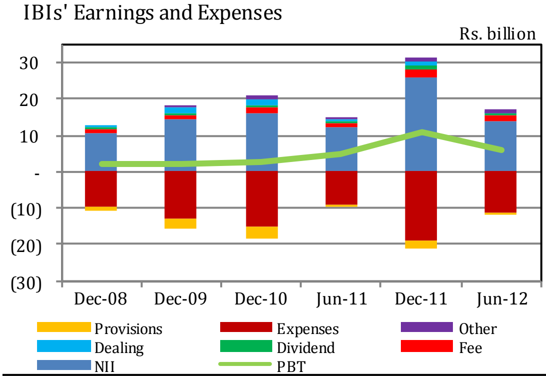


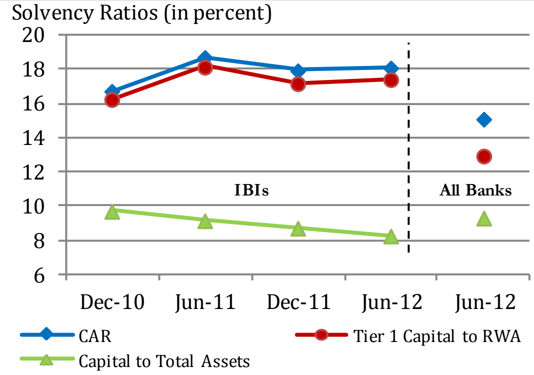
Table 4.3: Earnings (in percent)

	IBIs				All Banks
	Dec-10	Jun-11	Dec-11	Jun-12	Jun-12
Return on Assets	0.6	2.0	1.9	1.8	2.3
Return on Equity	5.9	20.7	20.8	20.6	24.9
Operating Expenses to Gross Income	72.6	60.9	60.4	64.7	52.5

Profit before tax is used in all calculations

Figure 4.9

Solvency Ratios (in percent)



financing used to be subdued, things started to deteriorate a bit, especially during the last year. The Non Performing Financing (NPFs) of IBIs saw, over the half year increase of 15 percent to reach Rs18.3 billion. Most of this increase was contributed by the Islamic Banks(IBs), which led to susbtaintail deterioration of their infection ratios **(Table 4.2)**. Fresh NPFs were observed mostly in textiles, and Chemical & Pharmaceutical sectors.

Profitability and solvency improved, though return indicators marginally subsided ...

The IBIs continued to experience growth in their earnings owing to imporved income from GoP Ijara Sukuks, non-mark-up income (dividend income and gain from sale of securities were instrumental in the increase) and decline in provisions **(Figure 4.8)**. The profit before tax edged up by 18 percent to Rs. 5.9 billion, with 47 percent of it contributed by the IBBs. In terms of optimal and efficient use of resources, the situation of IBIs slightly deteriorated as cost to income ratio (operating expenses to gross income) increased to **64.7** percent during H1-CY12 from **60.4** percent for CY11. This weakening alongwith decelration in financing income resulted in marginal dip in ROA **(Table 4.3)**. The solvency of the IBIs improved marginally to 18.1 percent as of H1-CY12, principally because of the accumulation of retained earnings **(Figure 4.9)**.