4 Islamic Banking

The increase in assets base of Islamic banking outpaces the growth in the overall banking sector as share of Islamic banking reaches 11.4 percent during CY15 in line with the 5 year strategic plan for Islamic banking industry (2014-18). In contrast to conventional banking industry's trend, flow of funds for financing activities outpaced investments. A major portion of financing has been extended under Diminishing Musharakah and Murabaha. The asset quality indicators show slight improvement; though Non-Performing Financings have increased marginally. The earning performance moderated due to high operating cost of IBIs owing to expansionary phase of Islamic Banking industry. The capital adequacy indicators remain lower than the conventional banking industry as few Islamic banks are in the process of building up their capital base.

Islamic Banking continues to grow both globally and domestically…

The global Islamic financial services industry has reached an overall total value of USD 1.88 trillion as of 2015 despite facing a series of economic challenges such as prolonged low energy prices, downward revised economic growth outlook, geopolitical conflicts, exchange rate depreciations and an assets sell-off spree in emerging markets. [122] The share of Islamic banking assets (USD 1.5 trillion) constituted around 80 percent of Islamic financial services industry's assets.

In Pakistan, the growth trend of Islamic banking industry continued in CY15 as well **(Table 4.1)**.

Table 4.1

Performance of Islamic Banking

	IBIs				Conv. Banks
	CY12	**CY13**	**CY14**	**CY15**	**CY15**
	PKR billion				
Total Assets	837	1,014	1,259	1,610	12,533
Investments (net)	394	394	357	432	6,449
Financing (net)	231	315	409	645	4,171
Deposits	706	868	1,070	1,375	9,015
	percent (YoY)				
Total Assets	30.5	21.2	24.2	27.9	15.5
Investments (net)	43.8	(0.0)	(9.5)	21.1	30.2
Financing (net)	15.5	36.2	29.7	57.9	3.3
Deposits	35.6	22.8	23.3	28.5	10.5

Source: FSD, SBP

Besides favorable domestic macroeconomic environment coupled with regulatory focus on development, following other factors have also contributed to the growth in the Islamic banking sector:

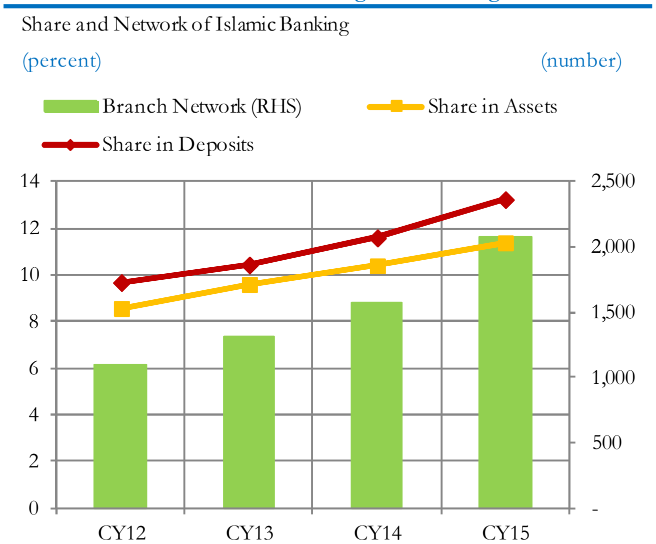
- Increasing branch expansion of IBIs[123];
- Establishment of first Islamic Banking subsidiary;
- Merger of two former conventional banks into Islamic banks;
- Expansion in virtual banking services including branchless banking.

122 IFSB, "Islamic Financial Services Industry Stability Report", 2016. According to the report, Banking Assets amounted to USD 1496.5 billion, Sukuk Outstanding were USD 290.6 billion, Islamic Funds' Assets were USD 71.3 billion and Takaful contributions stood at USD 23.2 billion. For more details, please see Table 1.1.1 and its explanatory note on page 7 in the IFSB's report.

123 Islamic Banking in Pakistan is offered through full-fledged Islamic Banks (IBs), Islamic Banking subsidiary of a commercial Bank (practically a full-fledged Islamic Bank) and stand-alone Islamic Banking Branches (IBBs) of conventional Banks. Together, these are called Islamic Banking Institutions (IBIs). Presently, 22 IBIs including 6 IBs (having 1028 branches) and 16 conventional banks (having 1047 IBBs) are offering Shariah compliant products and services.

IBIs assets are recorded at PKR 1.6 trillion which is 11.4 percent of the asset base of the overall industry (9.6 percent in CY13). The assets growth rate of 27.9 percent (YoY) of IBIs during CY15 outpaced the 15.5 percent growth rate of conventional banking industry. Main contributors in the assets growth are financings and investments (largely in Sukuk). In terms of penetration, the branch network of IBIs has also expanded by 501 branches as the branch network increased to 2,075 branches in CY15 as compared to 1,574 branches in CY14 **(Figure 4.1)**.

Figure 4.1
Share and network of Islamic Banking continued to grow



Source: FSD, SBP and IBD, SBP

This growth of Islamic banking industry, especially the share in the banking industry, is in line with SBP's 5 year Strategic Plan for Islamic Banking industry (2014-2018), which, inter alia, envisions Islamic banking industry to achieve 15 percent share in the entire banking industry's assets by the year end 2018.

Financing growth of IBIs outpaces the industry…

IBIs' financing growth at 57.9 percent as compared to conventional banking industry's growth of 3.3 percent has remained the hallmark of CY15. Apart from regular rise in financing, the sharp increase can also be attributed to other factors, which include merger of two conventional banks into Islamic banks. In addition, SBP's instructions wherein banks having IBBs were advised to show Islamic Financing and Related Assets under the head of "Advances" in their financial statements,[124] also provided boost to financings.

Private sector the main beneficiary of IBIs financing…

Private sector, with predominant share of 88 percent, has remained the main beneficiary of funds; with major allocation to textiles, chemicals and pharmaceuticals, sugar and agribusiness. Out of remaining 12 percent financing to the public sector, agribusiness and 'production and transmission of energy' received the major chunk.

Diminishing Musharaka dominates the modes of financing…

During CY15, 31.7 percent share of Diminishing Musharaka in overall financings of IBIs is more than any other mode of financings; while financing under Murabaha has 24.5 percent share (**Table 4.2**). Combined share of Ijara, Salam and Istisna comprises almost 20.5 percent of the financing portfolio of IBIs; whereas Musharaka and Mudaraba constitute 14 percent of the total financings.

[124] BPRD Circular Letter No. 5 dated February 29, 2016. If this factor is netted out, the growth of financing turns out to be around 40 percent which is still a handsome growth.

Table 4.2
Islamic modes of financing

	CY12	CY13	CY14	CY15
	percent share in total financings			
Murabaha	39.7	40.6	30.1	24.5
Salam	3.0	4.0	4.5	5.3
Istisna	7.2	5.6	8.3	8.6
Musharaka	0.8	6.7	11.0	14.0
Ijara	9.2	7.7	7.7	6.6
Car Ijara	4.4	4.9	5.3	4.2
Plant and machinery Ijara	2.1	1.6	1.5	1.4
Equipment Ijara	2.4	0.5	0.3	0.1
Others Ijara	0.3	0.7	0.6	0.9
Diminishing musharaka	35.7	30.8	32.6	31.7
Other Islamic modes of finance	4.3	4.4	5.6	9.2
Mudarabah	0.2	0.2	0.1	0.0
Qard/Qard-e-Hasan	0.01	0.01	0.01	0.01
Total	100.0	100.0	100.0	100.0

Source: FSD, SBP

Musharaka Financing, though saw an increase of 97.9 percent (YoY), still comprises only 14 percent share in total financing. The reluctance of the IBIs to venture into the sharing based mode of financing not only signifies their risk-averse approach but also calls for adaptation of better risk management practices to tap the underserved/neglected sectors of the economy with better returns. Moreover, challenges like moral hazard, displaced commercial risk, weak contract enforcement mechanism and reluctance by prospective borrowers to undertake profit & loss sharing commitments with the bank needs to be addressed so as to ensure a significant share of participatory modes in the financings of IBIs. In this regard, the Strategic Plan for the Islamic Banking Industry (2014-18) envisages developing incentive mechanisms and enabling policy environment to stimulate Musharaka and Mudaraba based financing.

Corporate sector remains the main recipient of IBIs funds…

In line with the historical trend, client-wise financing of IBIs has remained concentrated in corporate sector which is the top beneficiary of IBIs' financing with PKR 503.3 billion (74.4 percent of financings). Out of the such financing, PKR 215.1 billion (or 42.7 percent) are utilized for long-term investment, PKR 228.7 billion (or 45.4 percent) of the funds are utilized for working capital needs and PKR 59.5 billion (or 11.8 percent) for trade financing. The financing to corporate sector has registered a growth of 53.9 percent (YoY) (**Table 4.3**).

Table 4.3
Segement wise financing

	CY12	CY13	CY14	CY15	Growth
	PKR billion				percent
Corporate Sector:	179.0	236.2	327.0	503.3	53.9
Working Capital	76.9	94.5	138.8	215.1	54.4
Fixed Investment	89.4	109.3	148.1	228.7	55.0
Trade Finance	12.6	32.4	40.1	59.5	48.4
SMEs:	10.1	16.8	15.1	20.8	37.6
Fixed Investment	2.5	5.2	5.4	6.0	9.5
Working Capital	1.2	2.9	1.3	1.6	57.7
Trade Finance	6.4	8.6	8.4	13.2	26.3
Agriculture	0.2	0.3	1.8	4.3	142.5
Consumer Finance:	32.0	38.2	50.5	67.7	33.9
Housing Finance	13.5	15.9	19.0	25.0	31.5
Commodity Financing	17.8	31.6	22.7	58.2	157.0
Staff Loans	4.1	5.2	6.8	8.8	28.9
Others	0.4	0.8	1.5	13.9	836.8
Total	243.7	329.1	425.4	677.0	59.1

Source: FSD, SBP

Other sectors such as Consumer, SME and Agriculture also registered noticeable growth…

Consumer finance with PKR 67.7 billion (10.0 percent of financing) has registered an increase of 33.9 percent. Housing Finance has registered 31.5 percent (YoY) growth. Out of total Housing finance of PKR 43.3 billion, the share of IBIs has amounted to PKR 25.0 billion (57.8 percent share) as compared to conventional banks' amount of PKR 18.3 billion (42.2 percent share) **(Table 4.4)**.

Table 4.4

Housing Finance

	CY12	CY13	CY14	CY15
	PKR billion			
IBIs	13.5	15.9	19.0	25.0
Conventional	26.4	23.0	20.9	18.3
Industry (IBIs+Conventional)	39.9	38.9	39.9	43.3
	Percent share of Industry (IBIs+Conventional)			
IBIs	33.9	40.9	47.7	57.8
Conventional	66.1	59.1	52.3	42.2

Source: FSD, SBP

Although, SME and Agriculture financing constitute less than 4 percent share in total financing, SME has grown by 37.6 percent and Agriculture by 142.5 percent in CY15. SMEs and agriculture are among the potential sectors of growth for Islamic banking according to the findings of KAP survey released by SBP in October 2014[125]. In line with SBP's Guidelines on Islamic Financing for agriculture, Islamic Microfinance Business and Handbook on Islamic SME Financing, IBIs are moving forward with innovative products to tap the benefits of underserved sectors of the economy such as agriculture, SMEs and microfinance.

Investments of IBIs grow steadily…

After witnessing negative growth during CY13 and CY14, CY15 bode well for investments of IBIs as the growth surged to 21.1 percent **(Table 4.5)**. This rise, however, is still below the overall growth in investments of the conventional banks i.e. 30.2 percent. Lack of adequate supply of Shariah compliant liquidity instruments mainly contributed to lower than average growth in investments for IBIs.

125 Knowledge, Attitude and Practices (KAP) Survey http://www.sbp.org.pk/publications/Kap.htm

During CY15, the major investment avenue for IBIs has remained the Government of Pakistan (GOP) Ijara Sukuk which got a major boost after issuance of Rs 117.7 billion three-year Ijara Sukuk in December 2015. As a result, IBIs investment in Federal Government securities registered an increase of 27.9 percent (YoY), thereby constituting 71.2 percent of IBIs investment (net). On the contrary, the conventional bank's investment in Federal Government securities constituted 93.3 percent of their industry investment (net) portfolio.

This comparative position puts the IBIs at a relative disadvantage with respect to liquidity management, particularly short term liquidity. To overcome this issue, SBP is working to develop some Sukuk structures of shorter tenor in collaboration with SECP.

Table 4.5

Investments

	CY12	CY13	CY14	CY15	Growth
	PKR billion				percent (YoY)
Federal Government Securities	278.5	266.7	240.5	307.4	27.9
Fully paid up ordinary shares	3.5	4.3	5.4	12.0	125.1
Bonds/ PTCs/Sukuk certificates	33.9	34.0	45.1	56.7	25.8
Other investments	79.6	90.9	67.3	62.5	(7.2)
Total Investments	395.6	395.9	358.2	438.7	22.5
Provisions & deficit/ (surplus)	(1.2)	(1.5)	(1.5)	(6.7)	354.4
Investments (net)	394.4	394.4	356.7	431.9	21.1

Source: FSD, SBP

Deposits, the key funding source of IBIs, maintain growth momentum…

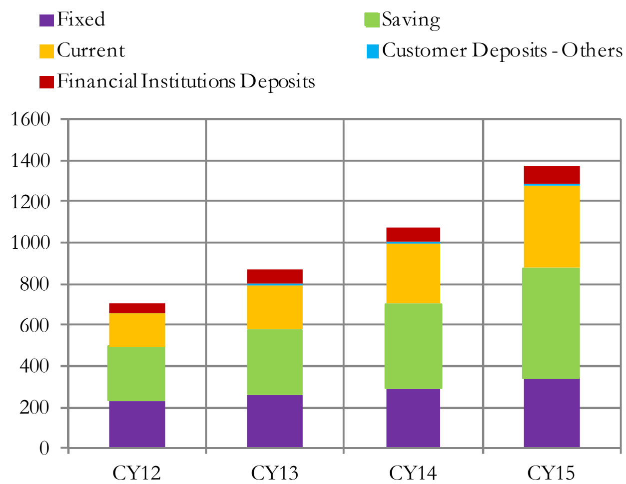
Deposits have remained the main funding source as IBIs successfully maintained their deposit growth momentum at 28.5 percent which outpaced the 10.5 percent growth rate of deposits of the conventional banks. Customers' deposits, at 93.4 percent of total deposits base, provided the pedestal for upholding the expansion in Islamic banking assets (**Figure 4.2**). Savings and Fixed deposits (generally, Mudaraba based) were recorded at 63.9 percent of the deposits whereas Current accounts (generally, Qard based) remained at 29 percent of the total deposits. Average deposit increase per Islamic Bank (excluding IBBs) works out to PKR 51 billion in CY15 compared with PKR 29 billion per conventional bank, on average.

Figure 4.2

Deposits maintain growth momentum

Deposits

(PKR billion)



Source: FSD, SBP

In terms of share in the deposits of IBIs, IBs outperformed the deposits growth of IBBs as IBs deposits grew by 29.9 percent as compared to IBBs deposits growth of 26.2 percent (**Figure 4.3**).

Fund based liquidity profile of IBIs remains comfortable…

The liquidity profile has remained satisfactory in CY15. Liquidity indicators like Liquid Assets to Deposits and Liquid Asset to Total Assets, at 41.2 percent and 35.1 percent, respectively, have showed signs of slight improvement over the previous year (**Figure 4.4**).

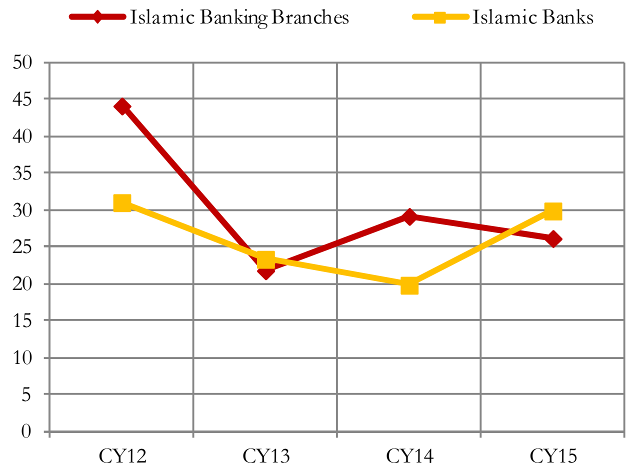
Financing to deposit ratio (**FDR**) at 46.9 percent, with an increase of 8.7 percent, has marginally surpassed the conventional banks' ADR of 46.3 percent in CY15.

Figure 4.3

IBs outpaced the deposits growth in IBBs

Proportionate Growth in Deposits

(percent)



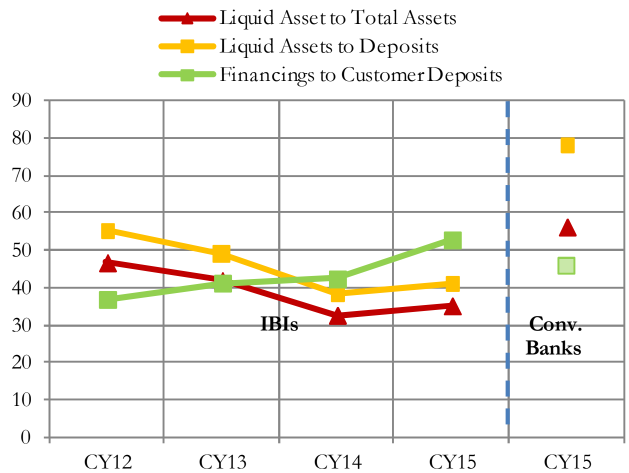
Source: FSD, SBP

Figure 4.4

Liquidity profile remained satisfactory

Liquidity Ratios

(percent)



Source: FSD, SBP

Asset quality remains at comfortable level…

On the asset quality front, IBIs have performed fairly well. Though Non Performing Financings (NPFs) to Total Financings registered an increase from 4.7 percent in CY14 to 4.9 percent in CY15, the provision coverage ratio has increased from 83.9 percent in CY14 to 95.6 percent in CY15. Resultantly, Net NPFs to Financing Ratio has declined from 0.8 percent in CY14 to 0.2 percent in CY15, whereas conventional banks' average is recorded at 2.2 percent. Similarly, Net NPAs to capital for IBIs has remained at 1.6 percent against the conventional banks' average of 7.8 percent (**Table 4.6**). All these indicators point to a comfortable level of asset quality of Islamic banks.

Table 4.6

Assets Quality

	CY12	CY13	CY14	CY15	Conv. Banks CY15
	percent				
NPFs to Total Financing	7.6	5.7	4.7	4.9	12.3
Provision to NPFs	66.5	74.4	83.9	95.6	84.3
Net NPFs to Net Financing	2.7	1.5	0.8	0.2	2.2
Net NPFs to Capital	9.8	6.9	3.9	1.4	7.4
Net NPAs to Capital	11.1	7.9	4.8	1.6	7.8

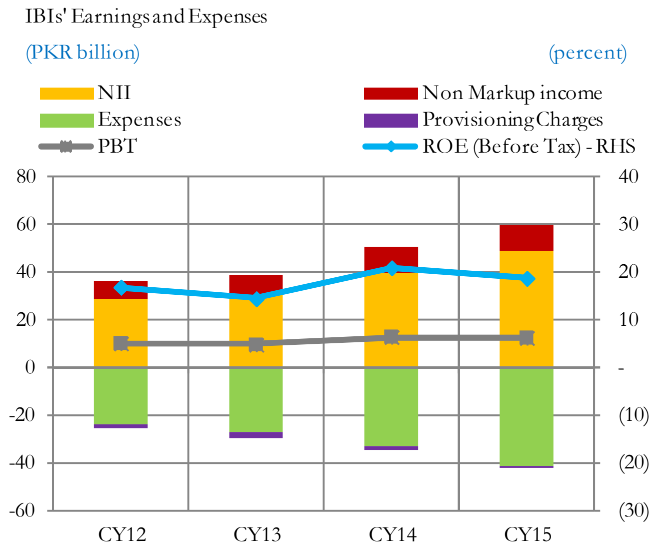
Source: FSD, SBP

Earnings under pressure due to expansion of outreach…

IBIs' earnings has, somewhat, moderated during CY15 as Return on Assets (ROA-before tax) has declined to 1.2 percent in CY15 as compared to 1.5 percent in CY14; which is also lower than the conventional banks' average of 2.7 percent. Net profit income to Gross income, with 80.9 percent share, has remained the major contributor towards the IBIs' earnings; while there is minimal support from Non Profit Income, with 19.1 percent share. Return on Equity (ROE-before tax) has also declined from 20.9 percent in CY14 to 18.7 percent in CY15; which is lower than the conventional industry average of 26.6 percent (**Figure 4.5**). Lower profitability for IBIs is understandable as they have access only to limited investment avenues (e.g. Ijara Sukuks) whereas conventional banks have access to ample interest based Government securities (PIBs and T-bills).

Figure 4.5

IBIs earnings moderated



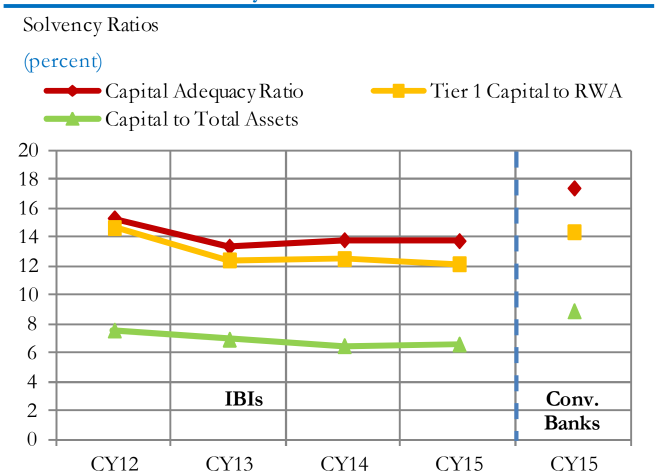
Source: FSD, SBP

Moderation in earnings indicators can be attributed to a host of factors such as decline in spread between financing and deposit rates (from 7.5 percent to 5.2 percent), decrease in income from dealing in FX and fall in profit on investments by 18.1 percent. Moreover, due to expansion in branch network, the administrative expenses have increased by 24.8 percent; operating expenses to Gross Income has surged (from 66.0 percent in CY14 to 70 percent in CY15) along with personnel expenses to operating expenses (from 38.6 in CY14 to 40.3 percent in CY15). The declining interest rate environment poses further challenge to the profitability of IBIs.

Capital adequacy is below industry average…

Overall, IBs have maintained CAR well above the required level of 10.25 percent. But, their CAR at 13.8 percent is well below the conventional banking industry's CAR of 17.4 percent. Few IBs are in the process of building up their capital base, therefore, capital adequacy indicators like Capital to Assets and Total Capital to Total RWA of IBs are lower than those of coventional banking industry's averages (**Figure 4.6**).

Figure 4.6
IBIs CAR remained steady



Capital Adequacy Ratio and Tier 1 Capital to RWA ratio are for Islamic Banks only, while Capital to Total Assets include both Islamic Banks and Islamic Banking Branches.
Source: FSD, SBP and BPRD, SBP

Way forward…

In view of the foregoing, it is obvious that the growth of Islamic banking has been quite impressive. The industry is still confronted with a number of challenges, though. Besides managing the risks faced by conventional banks, IBIs have to manage additional risks associated only with Islamic banking, such as Shariah non-compliance risk and displaced commercial risk. Similarly, Islamic banking is also facing limited availability of qualified and well trained human resource. Also, lack of understanding of prevalent Islamic banking theory and practice among the target audience is a stumbling block in sustainable development of the Islamic banking industry.

To address various issues and challenges faced by IBIs and to ensure fast paced development of the industry, concerted efforts are required from all the stakeholders. To this end, SBP has already launched comprehensive strategic plan for Islamic banking industry (2014-18) which sets out direction for the industry and also provides strategies with action plans. In this regard, the focused areas are: (i) enabling policy environment (ii) Shariah governance and compliance (iii) awareness and capacity building and (iv) market development.

Accordingly, various steps under the strategic plan have already been taken (summarized below) while others are expected to be completed by 2018:

- Implementation of Shariah Governance Framework for Islamic Banking Institutions (IBIs)
- Rationalization of Minimum Capital Requirements (MCR) for Islamic Banking Subsidiaries
- Awareness Creation and Capacity Building Programs for Islamic Banking Industry
- Establishment of Centers of Excellence in Islamic Finance Education (CEIFEs)
- Steering Committee for Promotion of Islamic Banking

In line with the enabling regulatory environment and governmental support, IBIs in their individual capacity and as an industry should also play an active role in further development of Islamic banking industry in Pakistan.