Islamic Banking Bulletin

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State Bank of Pakistan

ISLAMIC BANKING DEPARTMENT

Vision

To make Islamic Banking the banking of first choice for the providers and users of financial services

Mission

To Promote and Regulate Islamic Banking Industry in line with Best International Practices, ensuring Shariah Compliance And Transparency

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Deputy Governor’s Speech

Opportunities for Islamic Banking Institutions
Mr. Yaseen Anwar, Deputy Governor, Sate Bank of Pakistan
Al-Huda – International Conference on Islamic Banking and Takaful, Lahore
November 02, 2010

Ladies and gentlemen, first of all I would like to thank Al-Huda for inviting me on this occasion and to be part of this important discussion on Islamic banking and Takaful. I congratulate the organizers for this initiative by bringing together a diverse group of speakers from around the world. Al-Huda is complementing our efforts for creating awareness of Islamic banking and finance; we recognize and appreciate their role and efforts for the purpose.

From modest beginning, Islamic banking has established itself globally and is growing at a rapid pace. The size of the Islamic banking is expected to reach an estimated USD1,300 billion1 in near future. At present more than 1,100 institutions are offering Islamic financial services across the globe, which coupled with a number of dedicated Islamic academic, legal, regulatory and supervisory institutions’ provide a solid platform for future growth and development of the Islamic finance industry. In Pakistan, the Islamic banking initiative was re-launched by SBP in 2001 as an alternate and parallel system to provide an option to the public to enable them to choose the product that best serves their needs. Learning from the experience of 1980s, a comprehensive legal, regulatory and Shariah compliant framework was put in place before launching the initiative. The initiative has been a big success; the Islamic banking Industry has grown manifold since 2001 and at present the Islamic banking has reached total assets worth Rs 411 billion in June 2010, showing an impressive year on year growth of 31%. The year on year deposits growth has also been impressive 39% and the share of assets and deposits of Islamic banking have increased to 6.1 and 6.4 percent respectively. While Islamic banking branch network has increased to 667 branches and sub-branches spread across the entire country.

This overwhelming response from public for Islamic banking is not only encouraging but also brings many opportunities for Islamic banking institutions which are commonly called IBIs. Due to continuous growth of deposits, IBIs are fund surplus and they have opportunity to diversify their product mix by focusing on areas which are un-served and under-served areas. I would like to highlight the areas/opportunities where IBIs can focus their efforts and can get substantial benefits for the economy and their stakeholders.

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 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 % of the population in Pakistan is banked and has access to the formal financial system.

[1] Islamic Finance in the Global Economy Second edition by Ibragim Warde 2010.
[2] One bank branch for more than 17,000 people with branches highly concentrated in 10 big cities

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 strategically an important sector for the economy, having a 20% share of GDP and a major source of livelihood for 65% of the country's population living in rural areas. The sector is largely un-served/under-served by banks; less than 20% of about 7 million farm households in the country have access to bank credit3. The IBIs have also not yet entered the market significantly. They can capture a sizeable proportion of this market by reaching out to the growers either directly or through NGOs/Micro Finance Institutions. 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.

The SME sector is another potential area for Islamic banks to explore. Presently only 0.2 million SMEs have access to bank financing out of 3.1 million SMEs across the country[4;] the IBIs have just around 2,300 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 underwriting the risks and their capacity constraints in serving the non-traditional sectors like SMEs and agriculture. The conventional banks place their surplus funds in risk free government securities, while the Islamic banks presently do not have this oppurtunity. They should develop their capacity to deploy their surplus liquidity in avenues that have the potential to be the main drivers of growth for banks, including Islamic banks in the foreseeable future.

Similarly Housing finance is another 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 that is increasing due to supply shortage, the housing finance market is largely under developed; 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 develop partnerships with Federal and Provincial governments in developing/building low cost housing projects that are on the active agenda of federal and provincial governments.

Besides above, I would also like to point out that one of the advantages available to IBIs is to offer financing on Musharaka and Modaraba basis which is distinct from debt financing that is commonly undertaken by IBIs. The use of Musharaka and Modaraba financing is expected to better serve the underlying objectives of Islamic banking and finance of equitable and broad based distribution of profits and gains amongst the entrepreneur, banker and the depositor. Despite being accepted as a preferred and ideal mode of Islamic finance, the share of Musharaka/Modaraba financing in the total financing by IBIs is negligible. The key reasons for this insignificant market share of Musharaka/Modaraba given by the stakeholders are lack of transparency on part of borrowers, lack of capacity and risk appetite of Islamic bankers, the steady and consistent profit rate expectations by

[3] SBP Data
[4]SBP Data, Bureau of Statistics

Islamic depositors, regulatory constraints and taxation uncertainties. Let me, inform the audience that in order to steer the Islamic banking industry towards Musharaka/Modaraba financing, a Task Force on Musharaka/Modaraba Financing has been established at SBP. The key objectives of the Task Force are to review in detail the constraints faced in Musharaka/Modaraba financing, suggest recommendations for removing the indentified constraints and initiate Musharaka/Modaraba financing on larger scale in Pakistan.

I would like to reiterate that 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 provide competition to the conventional system, provided it capitalizes on its own inherent strengths and avoids replication of conventional system. The development and promotion of Islamic banking industry 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 a sound footing. We have plans to further improve our legal and regulatory framework to provide the necessary support and flexibility to the industry and enhance its commercial viability. Collaborative work with local and international stakeholders is underway to solve the liquidity management problem of Islamic Banks as well as trying to create awareness by facilitating and arranging conferences with all the stakeholders. Further we are 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.

In the end, I will again pay my tributes to the organizers for convening this event. I hope that the deliberations and discussions of this conference will help the industry in moving forward towards more inclusive growth and equitable distribution of gains in the economy.

Industry Progress and Market Share

Overview

Islamic banking industry has sustained growth momentum despite tenuous economic conditions prevailing in the country which were further exacerbated due to the recent floods in most parts of the country. The Islamic banking assets, deposits and financing continued exhibiting strong growth during the quarter with total assets increasing to Rs. 424 billion from Rs. 411 billion as at the beginning of the quarter; the Year on Year (YoY) growth in the assets was 31%. Similarly the deposits and financing and investments grew by 38.2% and 17.7% respectively and reached to Rs. 338 billion and Rs.233 billion as at the close of the quarter. The relatively lower growth in financing and investments is indicative of the difficulties being faced by IBIs in exploring new financing and investment avenues to deploy the growing deposits. The overall share of Islamic banking industry in the country's banking system also improved to 6.4% from 6.1% as at the beginning of the quarter[5].

Table 1: Industry Progress and market share

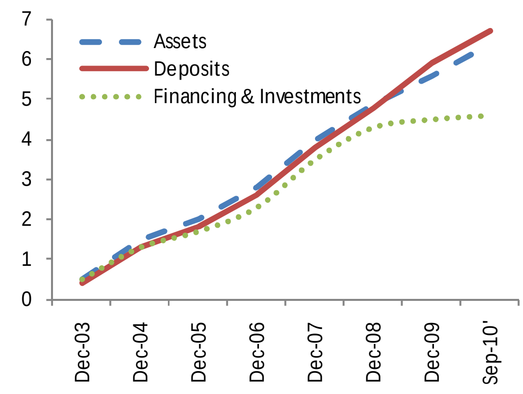
Rupees in billion & shares and growth in percent

	Sept 10	Dec. 09	Dec.08	Dec.07	Dec.06	Dec.05	Dec.04	Dec.03
Total Assets	424	366	276	206	119	71	44	13
Share in industry	*6.4*	*5.6*	*4.9*	*4*	*2.8*	*2*	*1.5*	*0.5*
Growth (YoY)	*31.2*	*32.7*	*34*	*73.1*	*65.3*	*63.6*	*238.5*	
Deposits	338	283	202	147	84	50	30	8
Share in industry	*6.7*	*5.9*	*4.8*	*3.8*	*2.6*	*1.8*	*1.3*	*0.4*
Growth (YoY)	*38.2*	*39.9*	*37.4*	*75*	*68*	*66.7*	*275*	
Net Financing & Investment	233	226	186	138	73	48	30	10
Share in industry	*4.6*	*4.5*	*4.3*	*3.5*	*2.3*	*1.7*	*1.3*	*0.5*
Growth (YoY)	*17.7*	*21.3*	*34.8*	*89*	*52.1*	*60*	*200*	
Total Islamic Banking Institutions	19	19	18	18	16	11	11	4
Total No. of Branches*	684	651	515	289	150	70	48	17

Source: Annual Accounts except for September 2010, data for which is based on Unaudited Quarterly Accounts
**number includes sub-branches*

While the relatively cautious approach of IBIs in assets' acquisition has enabled the IBIs to maintain relatively better quality of financing portfolio, it has slowed down the pace of asset buildup; the share of IBIs financing and investments is 4.6% compared to that of 6.7% of deposits. The widening gap in the growth rates of deposits and financing has been instrumental in pileup of huge liquidity surpluses in the industry (see Figure 1). While the recent issue of GOP Ijarah Sukuk of around Rs. 52 billion coupled with another tranche of Rs. 40-50 billion in December, 2010 would temporarily address the surplus liquidity issue, the IBIs will have to diversify their financing and investment avenues to find a long-term solution. The growing liquidity surpluses in Islamic banks however, is a universal problem as IBIs in almost all the jurisdictions are facing

Figure 1: Share of Islamic Banking(%)



[5] It is 100% in Iran, 27% in Saudi Arabia, 20% in Malaysia, 35% in Kuwait and 27% in UAE.

difficulties in deploying the growing deposit base. Perhaps, the solution lies in diversification of product mix and tapping non-traditional areas like SME, Agriculture and Microfinance, in a gradual manner.

Operating Performance

The profitability of IBIs in Pakistan—based on ROA, ROE etc.—is lower than the industry average. The tax adjusted ROE and ROA for IBIs as of September 2010 are 0.6% and 5.3% compared to the industry figures of 1% and 9.9%, respectively.

The declining profitability can be attributed to difficult economic conditions that have adversely affected the assets quality of banks including IBIs as reflected by significantly increased NPF ratio. Furthermore, the extensive branch expansion during last couple of years has also contributed in decline profitability ratios as the branched so opened are gradually achieving the break even.

Table 2: Performance Indicators

	Sept 09	June 10	Sept 10	Industry
Capital				
Capital to Total Assets	12.4%	10.4%	10.3%	9.9%
(Capital - Net NPAs) to Total Assets	10.7%	9.2%	8.7%	7.8%
Assets Quality Ratio				
NPFs to Financing	6.5%	6.5%	8.4%	14.0%
Net NPFs to Net Financing	3.0%	2.8%	4.1%	4.5%
Provisions to NPFs	55.0%	58.8%	54.1%	71.1%
Net NPFs to Total Capital	13.4%	11.5%	14.9%	21.6%
Real estate Financing to Total Financing	12.8%	10.8%	9.0%	0.0%
FCY Denominated Financing to Capital	8.6%	9.6%	7.2%	2.1%
Earnings and Profitability				
Net Income to Total Assets(ROA) after tax	0.7%	0.8%	0.6%	1.0%
Return on Equity (ROE) after tax	5.4%	6.9%	5.3%	9.9%
Net Income on Financing to Gross Income	79.0%	80.7%	80.0%	75.6%
Non-financing Income to Gross Income	21.0%	19.3%	20.0%	24.4%
Trading & Fx Gains/(Losses) to Gross Income	8.9%	8.0%	8.3%	7.4%
Operating Expense to Gross Income	67.2%	71.8%	73.9%	53.6%
Personnel Expense to Operating Expense	29.1%	32.1%	31.4%	35.5%
Spread Between Financing & Deposit Rate	6.9%	7.7%	7.7%	6.8%
Liquidity				
Liquid Asset to Total Assets	26.0%	25.8%	26.7%	33.6%
Liquid Assets to Deposits	34.3%	32.2%	33.5%	44.4%
Avg. Maturity of Liabilities (Days)	343	384	387	414
Avg. Maturity of Assets (Days)	712	596	577	594

Asset Quality:

During the quarter ending September 2010, the non-performing financing has shown 51% growth on YoY basis while the QoQ growth rate is 27%. It shows that the assets quality of IBIs is under strain. The non-performing financing reached to Rs 13.51 billion from Rs.10.65 billion as at the beginning of the quarter. The increased level of NPF is attributable to the difficult economic conditions in the country, which were further compounded by the recent heavy floods.

Table 3: Non-Performing Financing & Assets

Rupees in million

				Growth	
	Sept 09	June 10	Sept 10	YoY	QoQ*
NPF	8,947.13	10,649.88	13,511.35	51.0	26.9
Provisions	4,920.89	6,261.78	7,305.70	48.5	16.7
Net NPF	4,026.24	4,388.10	6,205.65	54.1	41.4
Recovery (year to date)	394.29	1,679.75	260.62	-33.9	-84.5
NPA	11,127.27	12,454.37	15,147.09	36.1	21.6
Net NPAs	5,375.57	4,921.07	6,498.77	20.9	32.1

The *Capital to Total Assets* ratio of Islamic banking industry is 10.3% as compared to industry which is 9.9%, while Capital-*net of NPFs to Total Assets* ratio of Islamic banking industry is 8.7% while the industry figure is 7.8%. The reason for IBIs having a sound capital base can be the fact that their target market comprises of blue chips firms which ensures sound collateral but also carries comparatively lower level of return.

Financing Products:

No major change was witnessed in the the Financing mix of IBIs during the quarter with Murabaha, Ijaraha and Diminishing Musharaka constituting around 89% of their financing mix. Some marginal improvement in Musharka based financing was however, observed as it improved to 3.6% from 2.6% last year. SBP, during the quarter constituted a broad based task force having representation of IBIs, business community, chartered accountants, academia etc to develop an incentive framework to promote participatory modes. The task force would develop the framework during the current fiscal year (i.e. FY11).

Table 4: Financing Mix

Rupees in billion

	Sept 09	June 10	Sept 10
Murabaha	50.6	72.4	69.31
Ijarha	29.8	23.8	21.80
Musharaka	3.6	6.0	1.85
Mudaraba	0.5	0.4	0.40
Diminishing Musharaka (DM)	38.5	46.4	51.39
Salam	1.7	3.2	1.22
Istisna	6.1	6.4	8.60
Qarz/Qarz-e-Hasna	0.0	0.0	0.02
Others	7.9	5.4	5.53
Total	**138.7**	**164.1**	160.1
% Share			
Murabaha	36.5	44.2	43.3
Ijarha	21.5	14.5	13.6
Musharaka	2.6	3.6	1.2
Mudaraba	0.4	0.2	0.2
Diminishing Musharaka (DM)	27.8	28.3	32.1
Salam	1.2	2.0	0.8
Istisna	4.4	3.9	5.4
Qarz/Qarz-e-Hasna	-	0.0	0.0
Others	5.7	3.3	3.5
Total	**100.0**	**100.0**	**100**

Sectoral Concentration of Financing:

The sector-wise concentration of IBIs financing is largely in line with concentration pattern of the banking system as a whole except chemicals & pharmaceuticals and 'individuals' where the IBIs have about 9.9% and 18.8% of their financing respectively compared to 4.3% and 12.5% for the banking system.

Table 5: Financing Concentration - percent share

	Sept 09	June 10	Sept 10	Industry
Chemical and Pharmaceuticals	7.55%	9.01%	9.91%	4.3%
Agribusiness	0.91%	1.09%	0.94%	6.1%
Textile	19.65%	18.11%	17.91%	16.8%
Cement	1.80%	3.44%	3.63%	2.7%
Sugar	2.40%	3.51%	2.30%	1.6%
Shoes and leather garments	1.36%	1.10%	1.19%	0.6%
Auto and transport equipment	2.52%	1.84%	2.53%	1.4%
Financial	1.07%	1.33%	0.96%	1.0%
Insurance	0.01%	0.01%	0.03%	0.0%
Electronics and electrical appliances	1.04%	0.87%	0.95%	1.6%
Production and transmission of energy	3.92%	4.79%	6.40%	9.6%
Individuals	22.22%	18.91%	18.83%	12.5%
Others	35.54%	35.98%	34.41%	41.7%
Total	100.00%	100.00%	100.00%	100.0%

Though no major change in the concentration patterns was witnessed during the quarter, there was some shift from textile and individuals to chemicals & pharmaceuticals, energy and cement during the last 12 months (Sep. 09 to Sep. 10). Further, the IBIs have negligible presence (of less than 1%) in Agribusiness compared to 6.1% of the banking system. The absence of IBIs in agribusiness is primarily attributable to concentration of IBIs branch network in big cities, limited understanding of IBIs about the sector and very few products offerings. With financial inclusion an important objective of SBP, it has been encouraging IBIs to venture into this largely untapped sector that has huge growth potential for banks including IBIs.

Investments

During the current quarter the IBIs investment rose by 3.5% on QoQ basis. More importantly, the YoY increase is a healthy 24.8%. The major contributor to the quarterly growth is a massive revaluation gain of 157.8%. These revaluation gains are counter intuitive in an increasing benchmark interest rates scenario—that results in revaluation losses on already acquired (fixed income) assets that yields less than the market rate. However, the inclining trend in the equity markets seems to have over-compensated the capital losses on fixed income investments.

Table 6: Investments

Rupees in million

	Sept 09	June 10	Sept 10	Growth YoY	Growth QoQ*
Federal government securities	24,662.6	27,032.7	27,029.6	9.60	(0.01)
Fully paid up ordinary shares	1,718.1	1,757.6	1,809.0	5.29	2.92
TFCs, Debentures, Bonds, & PTCs	21,428.0	26,173.8	28,510.2	33.05	8.93
Other investments	17,364.8	23,841.6	24,143.0	39.03	1.26
Investments by type					
Held for Trading	57.89				
Available for Sale	49,884.1	64,717.5	65,998.0	32.30	1.98
Held to Maturity	12,288.1	11,697.2	12,928.2	5.21	10.52
Surplus /(deficit) on revaluation	205.0	110.7	285.5	39.29	157.84
Net Investments	**64,678.4**	**77,999.7**	**80,690.5**	**24.76**	**3.45**

Except for the investment in federal government securities—that is stagnant QoQ--all investments categories have shown both YoY and QoQ rise. Nonetheless, SBP and other stakeholders, both domestic and global, are exploring new avenues for investments wherein IBIs can place their surplus funds and utilize their resources effectively and efficiently to optimize returns to depositors.

Deposit Mobilization:

The IBIs deposits though grew by just 3% during the quarter, the YoY growth was healthy 38%. The slower growth in deposits during the quarter could be attributed to recent floods and Eid related withdrawals in September 2010.

Table 7: Break up of Deposits

Rupees in million and growth in percent

	Sept 09	June 10	Sept 10	Growth YoY	Growth QoQ*
Deposits	**244,795.6**	**329,778.3**	**338,216.6**	**38.16**	**2.56**
Customers	**231,187.4**	**308,067.0**	**318,255.9**	**37.66**	**3.31**
Fixed Deposits	93,847.5	123,484.7	128,155.1	36.56	**3.78**
Saving Deposits	81,072.9	105,162.7	113,229.1	39.66	**7.67**
Current accounts - Remunerative	0.0	0.0	0.0		
Current accounts - Non-remunerative	54,261.0	76,676.9	74,266.1	36.87	**(3.14)**
Others	2,006.0	2,742.7	2,605.5	29.89	**(5.00)**
Financial Institutions	**13,608.2**	**21,711.3**	**19,960.7**	**46.68**	**(8.06)**
Remunerative Deposits	13,562.9	21,340.1	19,735.3	45.51	**(7.52)**
Non-remunerative Deposits	45.3	371.2	225.4	397.51	**(39.28)**
Currency Wise					
Local Currency Deposits	228,547.4	312,488.5	320,519.1	40.24	**2.57**
Foreign Currency Deposits	16,248.1	17,289.8	17,697.4	8.92	**2.36**

Consequently, similar pattern is exhibited in the YoY growth of fixed and saving deposits which stood at 37% and 40% respectively while the QoQ basis growth of fixed and saving deposits is 4% and 8%. Further, the deposits of financial institutions has increased on YoY basis by 47% but a declining trend was noticed on the QoQ basis which can be attributed to the fact that the IBIs are shifting their institution’s deposit to the interbank placements.

In terms of the currency denomination, the increase in deposits was mainly due to increase in the local currency deposits, which constituted around 40% while the foreign currency deposits increased by around 9%.

Maturity Profile of IBIs Assets and Liabilities

The maturity profile of IBIs is showing that there exists a mismatch in the assets and liabilities of different tenors. The asset-liability share gaps shows that IBIs are more liquid in shorter tenors compared to the market—more liabilities and less assets up to 1-year. This is not surprising and amply reflects IBIs difficulties/cautious approach in asset acquisition.

Table 8: Maturity of Assets and Liabilities

percent share

	Sept 09	June 10	Sept 10	Industry
Assets				
Maturing up to 3 months	37.7	42.9	48.0	41.64
Maturing from 3 months to 1 yr	22.5	22.6	17.9	29.16
Maturing from 1 yr to 5 yrs	26.4	25.1	25.0	17.18
Maturing after 5 yrs	13.3	9.4	9.1	12.02
Liabilities				
Maturing up to 3 months	58.6	54.3	52.9	55.54
Maturing from 3 months to 1 yr	25.2	25.5	27.2	22.23
Maturing from 1 yr to 5 yrs	11.0	15.0	14.7	16.11
Maturing after 5 yrs	5.2	5.2	5.3	6.12
Gap--asset share minus liability share				
Maturing up to 3 months	-20.9	-11.4	-4.8	-13.9
Maturing from 3 months to 1 yr	-2.6	-2.9	-9.3	6.9
Maturing from 1 yr to 5 yrs	15.5	10.1	10.4	1.1
Maturing after 5 yrs	8.0	4.2	3.7	5.9

Branch Network

Against a branch expansion plan of 247 branches for the whole year 2010, the YTD branch expansion stood at a 35 branches, implying that more than 200 branches should be added to meet the target.

The substantially slower pace of branch expansion can be attributed to the global financial markets' meltdown and deterioration in domestic economy that have possibly adversely affected expansion plans of banking institutions. IBIs seems to be looking to consolidate and stabilize the existing size in short term.

Table 9: Islamic Banking Branches

	Sep-10	Jun-10	Dec-09
Islamic Banks	437	416	400
Islamic Branches of Conventional Banks	197	183	168
Sub-Branches	50	68	81
Total	684	667	649
Province-wise			
	Sep-10	**Jun-10**	**Dec-09**
Punjab	306	297	290
Sindh	231	223	218
Khyber Pakhtunkhwa	73	73	70
Balochistan	33	33	32
Federal Capital	33	32	31
City-wise			
	Sep-10	**Jun-10**	**Dec-09**
Karachi	193	185	180
Lahore	117	113	109
Rawalpindi	33	31	31
Peshawar	29	30	28
Faisalabad	28	27	26
Multan	24	24	23
Quetta	22	22	21
Other	238	235	231
Total	684	667	649

Table 9, gives a summary of branch network of Islamic banking in Pakistan. During the quarter ended September 2010, Islamic banks have increased their branches by 21, while the conventional banks' Islamic banking branches rose by only 14—though much of the future growth is expected to come from conversion of the conventional bank branches to Islamic banking branches. Nonetheless, the trend of change of status of sub-branches to branches continued with 18 such upgrades (total upgrades YTD are 31).

The province-wise distribution of branches is heavily concentrated in Punjab and Sindh with the quarterly increase in branches also confined primarily to these two provinces. While the in rest of the provinces, no additional branch was opened. There is a single branch increase in federal capital. The city-wise distribution is primarily concentrated in urban centers with almost half of the branches in Karachi and Lahore.

Events & Developments at IBD

National Survey on Islamic Finance

A Survey conducted by "Fincon" regarding "Improving Access to Financial Services – Islamic Finance Component". The survey cover Islamic financial markets in Pakistan to provide important baseline data for monitoring the sector characteristics, demand & growth and information on current issues and opportunities for expansion and development, in particular in rural areas. It is a very useful and informative report providing reasonable amount of useful information about the current status and issues of Islamic banking in the country based on a survey conducted in 21 districts of Pakistan. The report is available at the following link on Asian Development Bank's website:

http://www.adb.org/Documents/Reports/Consultant/39492-PAK/39493-PAK-TACR-Vol6.pdf

SBP's Technical Assistance to Da Afghanistan Bank – Islamic Banking

A specialized course on Islamic banking and finance was arranged in NIBAF, Islamabad, for participants from Afghanistan. The participants included both the central and commercial bankers from Afghanistan. Pakistani experience of Islamic banking in terms of Shariah, legal, and regulatory frameworks was shared with Afghan brothers. The course covered the international Islamic finance infrastructure besides proving an excellent networking opportunity for Islamic finance professionals of both sides.

State Bank of Pakistan Shariah Board Meeting

Thirty second meeting of State Bank of Pakistan Shariah Board (SB) was held on September 15, 2010 in Learninig Resource Center (LRC) SBP. The meeting was chaired by Late Dr. Mahmood Ahmad Ghazi; (who died on 26th September 2010). A Joint Team of Duabi Islamic and Meezan Bank presented the proposed structure of Sukuk on Jinnah terminal, which was later approved after detailed discussion.

Islamic Banking News

Launch of IILM: An important Landmark

The signing on Monday by 11 central banks and two multilateral organizations of the articles of a memorandum of the International Islamic Liquidity Management Corporation (IILM), the latest transnational body to serve the global Islamic finance industry, potentially marks an important landmark in the 35-year-old contemporary Islamic finance movement. The IILM was launched at the inaugural session of the Global Islamic Finance Forum (GIFF) held in Kuala Lumpur in the presence of Malaysian Prime Minister Mohd Najib Tun Abdul Razak; Raja Nazrin Shah, the crown prince of the State of Perak and ambassador at large of the Malaysia International Islamic Finance Centre (MIFC) Initiative; Zeti Akhtar Aziz, governor of Bank Negara Malaysia, the central bank; and regulators and dignitaries from the Muslim world and beyond, including Muhammad Al-Jasser, governor of the Saudi Arabian Monetary Agency (SAMA).

"Malaysia," stressed Prime Minister Mohd Najib, "is honored to have been chosen to host the corporation. Its ultimate aim is to enhance international integration of the Islamic money market and capital markets and to be better equipped to face any liquidity crisis. I wish to commend the foresight, innovation and leadership displayed by the IFSB, the task force and participating parties for this breakthrough, which surely will help take Islamic finance to a higher level of development." Cont.....
arabnews.com/economy/article171837.ece

There is huge opportunity for Islamic banks with surplus Funds'

Deputy Governor, State Bank of Pakistan, Yaseen Anwar has said there is a huge opportunity for Islamic banks, which have surplus funds to fill the credit gap in private sector created by conventional banks that are investing in treasury bills. He was talking to media at the 4th International conference on Islamic Banking and Takaful, which was organised by Alhuda Centre of Islamic Banking and Economics here on Tuesday. He also said at present the Islamic banking was facing two challenges that were holding its growth; there was a need of capacity-building of Islamic bank institutions and awareness of Islamic banking products among the masses. "However, opportunities are there for Islamic banks to increase its market share by focusing on SMEs, micro-finance and housing finance," he added. Cont...
www.brecorder.com/.../1119844:there-is-huge-opportunity-for-islamic-banks-with-surplus-funds.html

Al Baraka Bank Rebranded after Merger

Al Baraka Islamic Bank Pakistan (AIBP), the branch operations of Al Baraka Islamic Bank (AIB) Bahrain, a subsidiary of Al Baraka Banking Group (ABG) Bahrain and Emirates Global Islamic Bank (Pakistan) have successfully merged their operations under the name of Al Baraka Bank (Pakistan) Limited (ABPL). The Head office will be located in Karachi.

ABPL will have assets in excess of Rs 50 billion, a workforce of 1,400 professionals and a network of 89 branches in 36 cities and town across the country. ABPL will commence operations and subsequently all the branches of Emirates Global Islamic Bank will be re-branded as ABPL. The merger, a first in the Islamic Banking sector in Pakistan, positions ABPL to play an important role in further growing an industry, which has witnessed a tremendous growth over the last 5 years. Substantial capital resources, combined with a nationwide branch network will enable ABPL to provide a full range of Islamic banking services, supported by the experience and expertise of the parent company, ABG. The operations of AIBP dating back to 1991, and at the time of merging its operations it had 29

branches across Pakistan, an asset base of Rs 31billion and profit-before-tax of Rs 168 million.
http://www.dailytimes.com.pk/default.asp?page=2010%5C11%5C02%5Cstory_2-11-2010_pg5_12

US$39 Billion Sukuk Globally Issued During Jan-Oct 2010

Sukuk worth US$5.3 billion were issued globally in October, taking the total issued in the first 10 months of 2010 to US$39 billion, according to data compiled by Zawya's Sukuk Monitor. Zawya's senior sukuk analyst Adnan Halawi said October was marked by diversity of issuing countries, with major issues from Qatar, Saudi Arabia, Malaysia and Indonesia. "Data from Zawya Sukuk Monitor shows that sukuk in the Gulf Cooperation Council is back on track and the rest of the world is warming up to the benefits of Islamic bonds," he said in a statement. The month concluded with Malaysia's toll-road operator Konsortium Lebuhraya Utara-Timur (Kesturi) issuing a RM820 million sukuk in the domestic market to redeem an existing sukuk. Cont……
www.gulfbase.com/site/.../NewsArchiveDetails.aspx?n... - Saudi Arabia

UK Government `Seriously Considering' First Sukuk issue

The British government may issue its first sovereign sukuk, or Islamic bond, by the end of the year, the head of a London-based Islamic lender has said. "They are seriously considering it," said Fahed Boodai, co-founder and chairman of Gatehouse Bank, a subsidiary of Kuwait's Global Securities House. When asked if an issuance is likely this year, he said; "I hope so." Gatehouse is a member of the UK Islamic Finance Secretariat, a group of Islamic banks and British government bodies. The group was established to bolster the sharia banking sector in the UK and to lobby for the issuance of the first UK sovereign sukuk. "Part of our developing business agenda is encouraging the UK government to issue a sukuk," James Bagshawe, chief operating officer at Gatehouse, said at the time. Cont…..
www.eubankers.net/page.Article.cmc?&A... - United Kingdom

Tata targets Gulf in India's first Shariah-compliant global fund

Tata targets Gulf in India's first Shariah-compliant global fund Bloomberg/Mumbai/Kuala Lumpur Tata Groups investment unit is seeking to attract about $100mn within three years to India's first Shariah-compliant fund aimed at global investors, targeting equities in a country that lacks regulations for establishing an Islamic debt market. The Tata Indian Shariah Equity Fund has $3mn after being set up in June to tap investment mainly from the Middle East, said Mumbai-based Tata Asset Management, which oversees $5bn in stocks and bonds, in an e-mailed reply to questions on Tuesday.India has no Islamic finance policies, restricting sales of Shariah-compliant bonds in a nation with 157mn Muslims, according to Paris-based BNP Paribas and Standard Chartered. The nations benchmark Sensex stock index rallied 16.5% this year, compared with a 13.6% advance for MSCI Incs emerging-market share index. Overseas investment in Indian equities climbed 86% this year to a record $26.1bn as of November 1.Cont……
www.businessweek.com/.../tata-targets-gulf-in-india-shariah-stock-fund-islamic-finance.html

Maldives gets first Islamic Bank

Malaysia's Islamic Banking and Finance Institute (IBFIM) and the Maldives Islamic Bank have signed a memorandum of agreement (MoA) to set up the Maldives' first Islamic bank, the Star Online reported on October 27, 2010. The bank is scheduled to be operational by January 2011. Both parties will co-develop Islamic finance in the country.
www.islamicfinance.de/?q=node/1413

Islamic Finance Outsources Sharia Supervision

Bankers in Islamic finance are increasingly outsourcing Sharia supervision due to a lack of scholars in the industry, but critics say this is making the sector even less transparent and slowing its development. The $1 trillion industry rode a five-year oil boom until the 2008 property crash in the Gulf Arab region raised complaints that many of its investment instruments can be seen as mere copy-cats of conventional banking products, threatening the sector's future growth.

Critics say growth and product innovation is being further stifled by the limited number of top scholars available to join the Sharia boards of Islamic banks, some sitting on up to 80 boards. "In banking you can lose a deal in one day," said John Sandwick, a Geneva-based Islamic wealth and asset manager. "If the scholars are not responsive, and we know it is literally impossible for one man to provide so much work, then everyone suffers," he said.
Instead of maintaining their own costly Sharia boards with prominent scholars, bankers are increasingly using consultancy firms that directly deal with the scholars. During the boom years, scholars in the Gulf Arab region allowed investment firms to book large amounts of up-front fees on the money they raised for property deals, violating the Islamic principle that risk and rewards should be shared. Cont...
www.financialislam.com/.../islamic-finance-outsources-scholars-supervision-to-grow.html

Islamic Banking 'Should Look at M&A for Growth'

Islamic banking, which has also been affected by the global financial crisis, should consider mergers and acquisitions as an avenue for sustained growth, said AT Kearney, the leading management consulting firm. The global financial crisis highlighted the need for consolidation in the Islamic banking industry in the region, it said.
Growing out of their niche and becoming mainstream business is considered one of their major challenges and if Islamic banks do not succeed, the room for further organic growth is limited as the market space in some GCC countries is already overcrowded, according to AT Kearney.

Some Islamic banking players are currently determining long term future plans, eyeing the opportunity to grow and become stronger players. Mergers and acquisitions offer a way to build more powerful players with better chances to compete," stated Dr Alexander von Pock, principal, Financial Institutions Group, AT Kearney Middle East. Cont...
www.tradearabia.com/news/bank_188074.html

State Bank of Pakistan raises Rs 52 billion from Ijara Sukuk: 65 percent target achieved

The federal government has achieved 65 percent target of Rs 80 billion. They borrowed through new 3-year Government of Pakistan Ijara Sukuk in its first auction. The State Bank accepted only Rs 51.837 billion bids. The cut-off margin over benchmark will be zero basis points. The benchmark is 6-month MTB Auction Weighted Average Yield. Sources in banking sector, are expecting another healthy participation in the second auction to be held on December 13, 2010.
http://www.brecorder.com/news/top-stories/1122505:sbp-raises-rs-52-billi ...

Saudi Arabia: IDB targets more sukuk issuances and mega interbank bank in 2011

THE Jeddah-based Islamic Development Bank will be preoccupied with two developments in 2011 apart from its established plan of action. This is the progress toward the launch of its mega bank project and the other is the continuation of its trust certificate (sukuk) program.

The mega bank project was promoted by Saleh Kamel, head of Dallah Albaraka Group, who has been trying to get it launched for the last few years. But his failure to get the project started off through the support of both government and private investors saw the project somehow passed on to the IDB. The plan is to launch a mega bank that will effectively be an Islamic Interbank bank, with the aim of providing short-term liquidity to the global Islamic banking market and of promoting the trading of sukuk in the secondary market by acting as a market maker.

CIMB of Malaysia, Citigroup, HSBC and Standard Chartered Bank acted as joint lead managers and joint book-runners, and NCB Capital of Saudi Arabia acted as co-lead manager for this transaction. The success of IDB's transaction was underpinned by a comprehensive international road show covering Asia, the Middle East and Europe.
http://www.zawya.com/story.cfm/sidZAWYA20101108032330/IDB%20targets%20mo...

Disclaimer: The news section of Islamic Banking Bulletin is based on information obtained from local and international print and electronic media and it may not reflect SBP views and policy.

Bank in Focus

Habib Metropolitian Bank Ltd (HMB) Islamic Banking Division[6]

HMB started Islamic Banking operations by opening first branch in Karachi in 2004. In October 2006 Habib Bank AG Zurich`s (HBZ) Pakistan Operations merged into Metropolitan Bank Limited along with its three Islamic Banking Branches and hence the number of Islamic Banking branches became four, three in Karachi and one in Lahore.

Bank's Performance at a Glance
Position as of Sept 2010

	(Rs in Millions)
Deposits	12,886
Financing	13,039
Total Assets	15,430
Number of branches	4

HMB Islamic Banking is focusing to provide its products and services utilizing the network of its conventional branches by opening "windows". As of September 30, 2010, it has opened 48 windows and through these branches Islamic products and services are offered. HMB Islamic also has Islamic Export Refinance, Foreign Bill purchase and Al Bai Financing Facility products. HMB IBD is planning to offer Salam and Istisna based products as well.

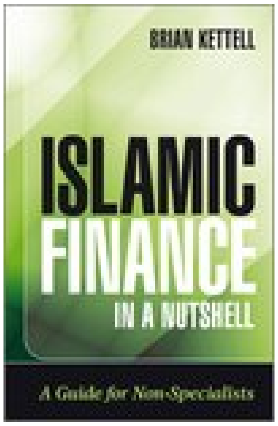
HMB Islamic has a renowned Shariah Adviser Mufti Muhammad Najeeb Khan, he possesses specialization in Islamic Jurisprudence and Shahadatul Almiah from Darul Uloom Faisalabad. He is one of a few Shariah scholars who have practical grip and is attached with the industry since beginning. He is member of number of committees, including Member of Task Force for Research and Development in Islamic Banking State Bank of Pakistan, Member of Committee on Accounting and Auditing Standards for Interest Free Modes of Financing and Investments (ICAP). He has attended several national and international seminars and conducted courses on Islamic Banking as well.

HMB Islamic claims to have trained and qualified staff which is fully capable of catering the business needs of the individuals, SMEs (Small and Medium Enterprises), Corporate and Retail customers seeking Shariah compliant products.

Besides the traditional general Banking Services, such as issuance of demand drafts, pay orders, handling of remittances, collection of Export Bills, collection of local bills, utility bills, opening of LC etc, the HMB Islamic Banking is offering Murabaha, Ijarah, Diminishing Musharakah on asset side for Corporate /Commercial /SME customers' various needs. On liability side, it has Current account, Savings account and Habib Islamic Investment Certificates (HIIC) of various maturities ranging from 1 month to 5 years with profit payment options of Monthly, Quarterly, and biannually for the tenors of One year and above.

[6] Contributed by HM-IBD.
For more information please visit http://www.hmb.com.pk/IslamicBanking.htm

Book Review:



Islamic Finance in a Nutshell: A Guide for Non-Specialists
Brian Kettell
ISBN: 978-0-470-74861-9
360 pages, April 2010

This book is available in SBP Library

Islamic Finance in a Nutshell: A Guide for Non-Specialist is a valuable addition to the Islamic finance literature. The author, being a seasoned professional of conventional as well as Islamic finance and a prominent academician, has put together various aspects of Islamic finance.

The book starts with a brief introduction of Islamic finance that conveys Shariah basis of Islamic finance. It discusses the prohibition of Riba, its types and its adverse consequences for the economy and society as a whole. Islamic modes of finance are elaborated with underlying conditions and benefits. The book also touches upon the Shariah law its primary and secondary sources. The role, responsibilities, selection criteria, fit and proper tests etc, of the Shariah board is also outlined. Another interesting and unique aspect of the book is the inclusion of CVs of prominent Shariah Scholars around the globe.

A whole section of the book is dedicated to financial analysis of Islamic banking institutions. The author has delved into both the liability and asset side. The provision of brief details of various deposit/investment products of Islamic banks is coupled with examples from financial accounts of Islamic financial institutions The author has reproduced the key indicators of top 500 Islamic financial institutions of the world for ready reference. A detailed overview of the Islamic financial infrastructure is provided including both the domestic and as well as the global perspective. The book gives introductory details, must-know-category, of key international Islamic financial institutions, like IFSB, AAOIFI, GCIBFI, IRTI, etc.

The appendices to the book are also a rich source of information. A comprehensive summary of Arabic terminologies with conceptual meaning is included that roughly encompasses Arabic words that a person dealing/interested in Islamic finance should know.

The contents of the book are unique in the sense that it covers diverse areas knitting them in one coherent text. The book can serve as a quick reference guide for the Islamic finance practitioners, professional and academicians.

Frequently Asked Questions[7] (Part VIII)

PRACTICAL ASPECT OF ISLAMIC BANKING

Question No. 41) If the Islamic banks do not lend money on interest then what modes of financing can be used for the following:
A) Trade and industrial finance
B) Financing the budget deficit
C) Acquiring foreign loans

Answer: As a matter of principle, all the financial transactions between the parties are lawful in the eyes of Islamic Shariah as long as they do not violate Islamic principles. Islamic Shariah provides several interest-free modes of finance that can be used to satisfy various business needs of the customer. These modes can be clubbed into two broad categories:

The first category may include modes of advancing funds on a **profit-and-loss-sharing basis**. Examples of profit and loss sharing category are Mudarabah, Musharakah and participation in the equity capital of companies. **The second category** may include the modes of finance which are used for the purchase/hire of goods (including assets) and services on a fixed return basis. Examples of this type are Murabaha, Istisna, Salam and Ijarah.

Therefore the financial needs can easily be met through interest-free legitimate modes of finance. These can be used to finance the trade, industry or a budget deficit through domestic or foreign sources. The following would further elaborate in detail.

A) Modes for financing trade and industry:

Murabaha, Musawamah, Ijarah and Salam are particularly suitable for trade while Istisna is especially suitable for manufacturing or construction industry. Further, the trade and industry needs financing for the purchase of raw materials, inventories (stock in trade) and fixed assets as well as to meet some working capital requirements. Murabaha can be used for the financing of all purchases of raw materials and inventory. For the procurement of fixed assets including plant and machinery, buildings etc. either Diminishing Musharakah or Ijarah can be more feasible. Funds for continuing/recurrent expenses can be obtained by the advance sale of final products of the company using Salam or Istisna and even Musharakah in appropriate circumstances.

B) Modes for financing a budget deficit:

It is noted that in an Islamic state, all the efforts should be made to avoid the budget deficit. However, in case of unavoidable circumstances, the budget deficit may be kept to the possible minimum limit. Sometimes the budget deficits are seen as a result of either extravagant (and/or unproductive) expenditure or insufficient and/or inefficient effort to generate tax revenue due to political, economical reasons or otherwise. There is a need to win public confidence about these needs and to create transparency in

[7] FAQs are included in order to create awareness about Islamic banking. These FAQs are already published and are available on SBP website (http://www.sbp.org.pk/departments/ibd/FAQs.pdf)

government expenditure. There is also a need to prevent the leakage of revenue generating streams for the Government. This can serve better in keeping budget deficits to a minimum level. In case of unavoidable deficits, government-owned enterprises can obtain finance by way of Mudarabah, Musharakah or Sukuk certificates, just like private companies do.

C). An alternative to foreign loans

Seeking Islamic solution to foreign borrowing, arrangements could be made to attract foreign as well as domestic funds through the following two ways:

i. The issue of certificates

Musharakah (partnership) or Ijarah certificates can be issued to finance the projects of the Government. Such certificates can be denominated in foreign as well as domestic currencies and they would carry a predetermined basis for sharing the profits earned through the respective projects. The certificates issued can be restricted to a particular project or earmarked to a group of projects.

ii. The establishment of funds

Funds can be created to finance the economic activities of public and private enterprises on equity, partnership, and Ijarah basis. These funds can attract funds through the issue of shares and certificates of various values and maturities and in domestic as well as foreign currencies. These can be established either to finance a certain sector (for example agriculture, industry and infrastructure), a particular industry (for example textiles, household durables, etc.), or a conglomerate of projects.

Question No. 42) If banking were to be based on interest-free transactions, how would it work in practice?

Answer: Islamic bank, like other banks, is an institution whose main business is to mobilize funds from savers and use these funds to finance the economic activities of businessmen/entrepreneurs. While a conventional bank uses the rate of interest for both obtaining funds from savers and lending these funds to businessmen, an Islamic bank performs these functions using various financial modes which are compatible with the Shariah. For mobilizing resources, it uses either the contract of Mudarabah or Wakalah with the fund owners. Under the first contract, the net income of the bank is shared between fund user (Mudarib) and fund providers (Rab-ul-Maal) according to a predetermined profit sharing formula. In the case of loss, the same is shared by fund providers in proportion to the capital contributions. As far as the nature of investment deposits are concerned, these could be either general investment deposits or specific investment accounts in which deposits are made for investment in particular projects. In addition, there are current accounts that are in the nature of an interest-free loan to the bank. The bank guarantees the principle in case of current accounts but pays no profit on such accounts.

Under the Wakalah contract, clients give funds to the bank that serves as their investment manager. The bank charges a predetermined fee for its managerial services. The profit or loss is passed on to the fund providers after deducting such a fee.

On the assets side, the bank uses a number of financial instruments none of which involves interest. A wide variety of such modes of financing is available as discussed before.

Question No. 43) Do we really need Islamic banking?

Answer: The question may be divided into following two parts for proper understanding:

1. Do we need bank?
2. If yes, why it should be on the basis of Islamic Shariah.

i. Do we need bank?

In order to assess the need of the bank, we need to look at the functions it performs. In any society, be it a secular or Islamic one, the main function of the bank is to mobilize funds from the surplus units and allocate these to the shortfall units or to the units having budget constraints. This function is performed through the process of financial intermediation in the financial markets where banks are the most important operators. Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the requirements and availability of financial resources of savers and entrepreneurs in an economy.

Normally the surplus units/savers are the small households or individuals who save relatively small amounts whereas the entrepreneurs are firms which often need relatively large amounts of funds. Financial intermediation removes this size mismatch by collecting the small savings and packaging them to suit the needs of entrepreneurs. In addition, entrepreneurs may require funds for periods relatively longer than would suit individual savers. Intermediaries resolve this mismatch of maturity and liquidity preferences again by pooling small funds. Moreover, the risk appetite of savers and entrepreneurs are also different. It is often considered that small savers are risk averse and prefer safer placements whereas entrepreneurs may wish to deploy funds even in risky projects. The role of the intermediary again becomes crucial. They can substantially reduce their own risks through the different techniques of proper risk assessment and risk management. Furthermore, small savers cannot efficiently gather information about opportunities to place their funds. Financial intermediaries are in a much better position to collect such information which is crucial for making a successful placement of funds.

The role and functions of banks outlined above are indeed highly useful and socially desirable. Hence, we reach to the point where the banks become the need of any economy.

ii. Why the bank should be on the basis of Islamic Shariah?

Commercial banks normally operate on lending basis. They may not be much bothered about the use of funds as long as the borrower pays back the loan regularly. This does not ensure that the amount advanced to the borrower was used for the productive or unproductive purpose. Thus the impact of commercial banking on economic development, therefore, may remain below potential. Whereas, Islamic bank provides finance which has a greater focus on the productive use. Islamic banks' financing targets both the equity as well as the working capital needs of enterprises. It is expected that its impact on economic development will be more pronounced. The avoidance of interest by Islamic banking is an additional plus. It is mentioned that allocating financial resources on a productive basis is more efficient than their allocation on a purely lending basis. It has also been argued that the whole banking system would be more stable and less liable to suffer from financial crises. A monetary system based on riba is also unjust as it allows savers and banks to get away with interest (guaranteed fixed rate of return on their loans) without bearing a fair part of the risks faced by entrepreneurs.

Question No. 44) Is Islamic banking viable?

Answer: Islamic banking is still in the stage of evolution. No one disputes that there is a definite desire amongst Muslim savers to invest their savings in the venues which are permitted by the Shariah. Nevertheless, they must be provided with halal returns on their investments. Islamic scholars and practical bankers took up this challenge and have made commendable progress in the last few decades in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.

Islamic banking and financial institutions have now spread across several Muslim countries as well as non-Muslim countries. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving. Theoretical arguments and models developed by Islamic economists and the successful practice of hundreds of institutions in heterogeneous conditions both testify to the viability of Islamic banking as Islamic banking model provides a complete banking solution to all the business needs of the customers while remaining with the boundaries of Shariah. The average growth rate of assets in Islamic banks over the past twenty years has been around fifteen percent per annum. Islamic banking institutions have come of age now and are realizing a high degree of success in respect of market penetration. This is considered remarkable in view of the fact that the markets in which these Islamic banks were established have had highly developed and well-established commercial banks as their competitors.

Another manifestation of the success of Islamic banking is the fact that many conventional banks have also started using Islamic banking techniques in the conduct of their business, particularly in dealing either with Muslim clients or in predominant Muslim regions.

Question No. 45) How does Islamic banking fare vis-à-vis conventional banking?

Answer: The approach of Islamic banking to satisfy the business needs of the customers is entirely different from that of the approach adopted by conventional banking. Basically Islamic banking satisfies the business needs of the entrepreneurs by the following two modes:

1. Profit and Loss sharing modes
2. Debt creating modes (financing the purchase of commodities on credit with a mark-up)

On the other hand conventional banking satisfies the business needs of the entrepreneurs by charging fixed interest which raises several questions. Although the results of operations of an enterprise in which such loans are to be invested are by no means certain, yet, guaranteeing in advance, a fixed return on a loan without taking into consideration the actual results of the operations of the borrowing enterprise puts all business risks on the entrepreneur/borrower.

The Islamic banking philosophy is not based on interest because according to Islam, interest is haram and a curse in society. Islamic banking focuses on the common good, encourages highest ethics such as universal brotherhood, collective welfare and prosperity, social welfare and justice. On the other hand, interest based system accumulates money around handful of people and it results inevitably in creating monopolies, opening doors for selfishness, greed, injustice and oppression.

Further, the allocation of financial resources on the basis of profit-and-loss sharing gives maximum weight to the profitability of the investment whereas an interest-based allocation gives it to credit worthiness. It is expected that the allocation made on the basis of profitability would be more efficient than that made on the basis of interest.

Moreover, a system based on profit sharing would be more stable compared to the one based on a fixed interest rate on capital. In the latter, the bank is obliged to pay a fixed return on its obligations regardless of their fate, should the economic conditions deteriorate. In the former, the return paid on the bank's obligations depends directly on the returns of its portfolio of assets. Consequently, the cost of capital would adjust itself automatically to suit changes in production and in other business conditions. Furthermore, any shock which might befall the obligations' side of the balance sheet would be automatically absorbed. This flexibility not only prevents the failure of the enterprises seeking funds but also ensures the existence of a necessary harmony between the firm's cash flow and its repayment obligations. This is the main element which enables the financial system to work smoothly. Since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) become the prime movers of the rates of return to the financial sector.

The transformation of an interest-based system into profit sharing system helps in the achievement of economic growth which results in increasing the supply of venture or risk capital and consequently encourages new project owners to enter the realm of production as a result of more participation in the risk-taking.

Question No.46) How can Islamic banking institutions avoid money laundering and such kind of other illegal/illegitimate activities?

Answer: In the post –9/11 global scenario, anti money laundering measures by regulatory authorities of banking and finance have gained extraordinary importance. It is pertinent to indicate in this regard that Islamic banks, by their nature, are less likely to engage in money laundering and other illegal activities. They cannot undertake activities which are detrimental to society, because to ensure the adherence of moral values, it has to go through an exhaustive test of Shariah compliance. Islamic banks are not allowed to invest in narcotics, casinos, nightclubs, alcoholic drinks etc. This requires that the clients of Islamic banking must have business which should be socially beneficial for the society, creating real wealth and adding value to the economy rather than making paper transactions. Therefore, a more stringent 'Know Your Customer' (KYC) policy is an in-built requirement for an Islamic bank.

Islamic modes of financing and deposit-taking discourage questionable or undisclosed means of wealth which form the basis of money-laundering operations. Islamic financing modes are used to finance specific physical assets like machinery, inventory and equipment etc. Further, the role of Islamic banks is not limited to a passive financier concerned only with timely interest payments and loan recovery. Islamic bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. To avoid the loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele. As such, Islamic banks are less likely to engage in illegal activities such as money laundering and financing of terrorism than conventional banks.

However, the existence of rogue elements cannot be ruled out in any type of organization. Keeping this in view, Pakistan has adopted a strategy by adopting uniform international standards to ensure fair play by all kinds of banks and financial institutions including Islamic banks. It has also put in place stringent regulations in order to effectively curb money laundering. The 'Know Your Customer' (KYC) regulation has been sharpened to provide more detailed guidelines to banks/DFI's for due diligence in respect of customers. All banks are required to properly investigate transactions which are out of character with the normal operation of the account involving heavy deposits/withdrawals/transfers.

(to be continued ……)

Annexure: I

Islamic Banking Branch Network

(As of September, 30, 2010)[8]

Type	Name of Bank	No of Branches[9]
Islamic Banks	Al Baraka Islamic Bank (Pakistan) Limited*	29
	BankIslami Pakistan Limited	70
	Dawood Islamic Bank Limited	42
	Dubai Islamic Bank Pakistan Limited	36
	Emirates Global Islamic Bank Limited*	58
	Meezan Bank Limited	202
	Sub Total	437
Islamic Branches of Conventional Banks	Askari Bank Limited	29
	Bank Alfalah Limited	65
	Bank Al Habib Limited	8
	Faysal Bank Limited	10
	Habib Bank Limited	12
	Habib Metropolitan Bank Limited	4
	MCB Bank Limited	13
	National Bank of Pakistan	8
	Soneri Bank Limited	6
	Standard Chartered Bank (Pakistan) Limited	15
	The Bank of Khyber	19
	The Royal Bank of Scotland	3
	United Bank Limited	5
	Sub Total	197
Sub Branches	Askari Bank Limited	2
	BankIslami Pakistan Limited	32
	Dawood Islamic Bank Limited	8
	Emirates Global Islamic Bank Limited	2
	Meezan Bank Limited	3
	The Bank of Khyber	3
	Sub Total	50
	Grand Total	684

[8] Al Baraka Islamic Bank and Emirates Global Bank Ltd merged into Al Baraka Bank (Pakistan) Limited on Oct 30, 2010, for detail please see notification at www.sbp.org.pk/notifications/bpd/2010/index.htm

[9] *Source: Banking Policy & Regulations Department, State Bank of Pakistan.*

Annexure: II

Province wise Break-up of Islamic Banking Branch Network

(As of September, 30, 2010)[10]

Type	Bank Name	Azad Kashmir	Balochistan	Federal Capital	Khyber Pakhtunkhwa	Northern Areas	Punjab	Sindh	Grand Total
Islamic Banks.	Albaraka Islamic Bank	1		2	3		15	8	29
	BankIslami Pakistan Limited	1	8	2	5	1	30	23	70
	Dawood Islamic Bank Limited		1	2	1		18	20	42
	Dubai Islamic Bank Pakistan Limited		3	2	4		16	11	36
	Emirates Global Islamic Bank Limited		3	2	6		27	20	58
	Meezan Bank Limited	2	5	9	18		97	71	202
IB. Total		4	19	19	37	1	204	153	437
Islamic Branches of Conventional Banks	Askari Bank Limited		2	1	5		14	7	29
	Bank AL Habib Limited		1		1		2	4	8
	Bank Alfalah Limited		1	4	3		40	17	65
	Habib Bank Limited		1	1	2		5	3	12
	Habib Metropolitan Bank Limited						1	3	4
	MCB Bank Limited		1	1	1		6	4	13
	National Bank of Pakistan	2			1		3	2	8
	Soneri Bank Limited		1	1	1		1	2	6
	Standard Chartered Bank(Pakistan)		1	1	3		3	3	11
	The Bank of Khyber		2		12		3	2	19
	The Royal Bank of Scotland						1	2	3
	United Bank Limited				1		3	1	5
	Faysal Bank Limited		1		3		4	6	15
SAIBBs Total		2	11	9	32		87	56	197
Sub Branches	Askari Bank Limited			1				1	2
	BankIslami Pakistan Limited	1	3	3	2		9	14	32
	Dawood Islamic Bank Limited						3	5	8
	Emirates Global Islamic Bank Limited			1				1	2
	Meezan Bank Limited				1		2		3
	The Bank of Khyber				1		1	1	3
Sub Branches Total		1	3	5	4		15	22	50
Grand Total		7	33	33	73	1	306	231	684

[10] See foot note 9 on page---

Annexure: III

City wise Break-up of Islamic Banking Branch Network

(As of September, 30, 2010)

S.No	Province	Cities	No of Branches
1	Sindh	Badin	1
2		Hyderabad	17
3		Karachi City	193
4		Larkana	1
5		Matiari	1
6		Mirpur Khas	3
7		Nawabshah	4
8		Sakrand	1
9		Sanghar	2
10		Sukkur	5
11		Tando Adam	1
12		Tando Allahyar	2
	Sindh Total		**231**
13	Punjab	Arifwala	1
14		Attock	4
15		Bahawalpur	3
16		Chakwal	2
17		Daska	1
18		Dera Ghazi Khan	2
19		Faisalabad	28
20		Gojra	1
21		Gujar Khan	1
22		Gujranwala	10
23		Gujrat	10
24		Hafizabad	2
25		Jaranwala	2
26		Jhang	3
27		Jhelum	4
28		Kamoki	1
29		Kasur	2
30		Khanewal	1
31		Khushab	4
32		Lahore City	117
33		Mandi Bahauddin	1
34		Mian Channu	2
35		Mianwali	1
36		Multan	24
37		Okara	2
38		Pakpattan	1
39		Pindi Ghaib	1
40		Rahim Yar Khan	6
41		Rawalpindi	33
42		Sadiqabad	2
43		Sahiwal	3
44		Sargodha	6
45		Sheikhupura	3
46		Sialkot	13
47		Texila	1
48		Toba Tek Singh	1
49		Vehari	4
50		Wah Cantt	3
	Punjab Total		**306**

S.No	Province	Cities	No of Branches
51	Northern Areas	Gilgit	1
	Northern Areas Total		**1**
52	Khyber Pakhtunkhwa	Abottabad	11
53		Banu	1
54		Batkhela	1
55		Charsadda	1
56		Chitral	1
57		Dera Ismail Khan	3
58		Hangu	1
59		Haripur	3
60		Kohat	2
61		Mansehra	6
62		Mardan	5
63		Mingora	1
64		Nowshera	3
65		Peshawar	29
66		Swabi	2
67		Swat	1
68		Tank	1
69		Timergara	1
	Khyber Pakhtunkhwa Total		**73**
70	Federal Capital	Islamabad	33
	Federal Capital Total		**33**
71	Balochistan	Chaman	1
72		Gawadar	1
73		Hub Chowki	1
74		Kuchlack	1
75		Loralai	2
76		Muslim Bagh	1
77		Pishin	1
78		Qilla Abdullah	1
79		Qilla Saifullah	1
80		Quetta	22
81		Zhob	1
	Balochistan Total		**33**
82	Azad Kashmir	Mirpur AJK	4
83		Muzaffarabad	3
	Azad Kashmir Total		**7**
	Grand Total		**684**

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