

Islamic Banking Bulletin

September 2011

**Islamic Banking Department
State Bank of Pakistan**

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Deputy Governor's Speech

At the Closing Ceremony of IRTI-SBP Training Programme at NIBAF, Islamabad (Nov 21-25, 2011)

Brother Dr. Osman Babiker, Mr. Amer Aziz MD NIBAF and dear participants, Assalam-o-alikum. It is real pleasure to be here at the certificate distribution ceremony of this first ever training program on Islamic banking jointly organized by IRTI and SBP. IRTI; as the research and training arm of the Islamic Development Bank Group has played a key role in development of Islamic Financial Industry in the member countries through its research and development and capacity building initiatives. My sincere thanks to IRTI and especially to Dr. Osman Babiker and Mr. Mushtaq for working with us on this very important initiative; without their hard work and continuous support the successful conduct of the program would have been very difficult. I am sure that Insha Allah the cooperation and collaboration between IRTI and SBP would continue to build the industry's HR capacity and also explore new vistas for growth and development of the industry. I am also grateful to the foreign speakers and participants from brotherly countries of Iran, Turkey, Maldives and Bangladesh for their participation in the program and I hope that they have a very pleasant stay in Islamabad. NIBAF and IBD team would have taken good care of them and they would take good memories back home; much different from the general perception and picture portrayed by international media.

This program I believe would have enabled the participants, particularly the international delegates, to have a better understanding of Islamic banking philosophy and the developments taking place in the industry at local and global level. Looking at the theme, structure and content of the program one can discern that besides discussing the basic Islamic Banking concepts, instruments and models, it also tried to cover the issues like growing public debt and its implications on global economic and financial environment and the potential of Islamic economic system to address and resolve these issues and challenges. I am sure that the speakers would have covered these areas in considerable detail enabling the participants to better appreciate the background and reasons for the financial crisis and inbuilt checks and balances of Islamic economic system to avoid build up of any such crisis.

The asset backed nature of Islamic financial transactions, coupled with prohibition of sale of debt and investments in speculative activities ensures growth of finance in tandem with the growth of real economy and thus lends prudence and stability to the financial system. The resilience of Islamic financial institutions during the recent international financial crisis has testified the ability of Islamic economic and financial system to lend the much needed stability to the financial systems, which have been experiencing crisis with increasing frequency. Encouragingly, post crisis there has been significantly increased recognition of Islamic finance as a more prudent, stable and better alternate to the conventional system, which gives us the optimism about Islamic finance industry.

The Islamic Banking Industry since its re-launch in 2001 has gradually increased its share and presently constitutes about 7.3% of the overall banking system in Pakistan. There are currently 5 full fledged Islamic banks and 12 conventional banks having Islamic banking branches with a network of more than 840 branches in more than 70 districts across the country. The industry has been maintaining strong growth momentum with over 30 percent average annual growth during last 6-7 years; this growth trend is likely to gather further momentum with increasing awareness level and expansion of Islamic banking network in second and third tier cities.

Ladies and Gentlemen; The strong growth momentum witnessed by the industry could be attributed among others to the key role played by State Bank of Pakistan in providing an enabling environment. The State Bank has been at the forefront of almost all the initiatives to help develop the industry and promoting Islamic finance has remained an important component of its strategic goals. Besides developing a supportive regulatory and supervisory framework it is actively engaged in promotion, training and capacity building of the industry. To address the awareness and misconception issues we have launched an awareness campaign whereby targeted seminars and conferences are being organized for business community, academia, bankers and policy makers throughout the country. Further, a media campaign is being launched for mass awareness using electronic and print media. Similarly a number of initiatives have been taken to build the industry's HR capacity and skills mix. The financial and technical support of reputed national and international organisations like IRTI, IFSB is also being mobilized to organize training and capacity building programs. Our membership and active engagement with International Islamic Financial Institutions like Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Financial Market (IIFM) also helps us in leveraging their resources for our awareness and capacity building initiatives. We believe that these collaborative efforts would translate into significant improvement in the industry's HR capacity and public awareness levels about Islamic banking in the near future. Similarly we are actively engaged with the industry to diversify the product mix and develop cost effective liquidity management solutions.

I believe, the training programs like this on international level, besides building the HR capacity, can play a pivotal role in addressing the challenges faced by the industry. Such programs provide an opportunity to share experiences for mutual benefit and also spark debates on how new and innovative solutions may be found to resolve some of the critical issues faced by the industry. Given the dire need for work in field of Human development I am sure that this program will prove to be a stepping stone for future collaboration with IRTI on a more proactive, long term and consistent basis.

In the end, I would like to thank all the local and international speakers and participants in particular the Islamic Research and Training Institute (IRTI) team for coming here and wish all our foreign guests a safe journey back home.

Islamic Banking Industry - Progress & Market Shares

Overview

As of end Sep'11, the total assets of the Islamic Banking Industry (IBI) stood at Rs. 568 billion, constituting 7.3 percent share of overall banking industry (see **Table 1**). Deposits of IBI reached Rs. 463 billion during the quarter under review and its share increased to 8 percent of the overall banking industry from 7.6 percent in the last quarter (April-June 2011); the YoY growth of the deposits was almost 37 percent. However, investments growth decelerated while financing witnessed retrenchment compared to the previous quarter. The deceleration in growth of investment can be explained by the non-issuance of any new Sukuk during the quarter while the retrenchment in financing is due to the business cycle of most corporate clients as well as the overall economic conditions of the country. The industry witnessed rising non-performing financing (NPF) during the period under discussion reaching Rs. 15.7 billion from Rs. 14.8 billion during the last quarter, even so the IBI continued to achieve higher profit and increase in earnings.

Table 1: Industry Progress and market share

	Islamic Banking Industry Progress						Share in Overall Banking Industry		
	Islamic Banking Industry Progress			Growth (YoY)			Share in Overall Banking Industry		
	Sep-10	Jun-11	Sep-11	Sep-10	Jun-11	Sep-11	Sep-10	Jun-11	Sep-11
Total Assets	424	560	568	31.2%	36.3%	34.0%	6.4%	7.3%	7.3%
Deposits	338	452	463	38.2%	37.1%	36.9%	6.7%	7.6%	8.0%
Net Financing & Investment	233	420	414	17.7%	78.3%	77.3%	4.6%	7.0%	6.8%
Total Islamic Banking Institutions	19	17	17	-	-	-	-	-	-
Total No. of Branches*	684	799	841	-	-	-	-	-	-

Source: Quarterly Unaudited Accounts

*number includes sub-branches

IBI Network Expansion

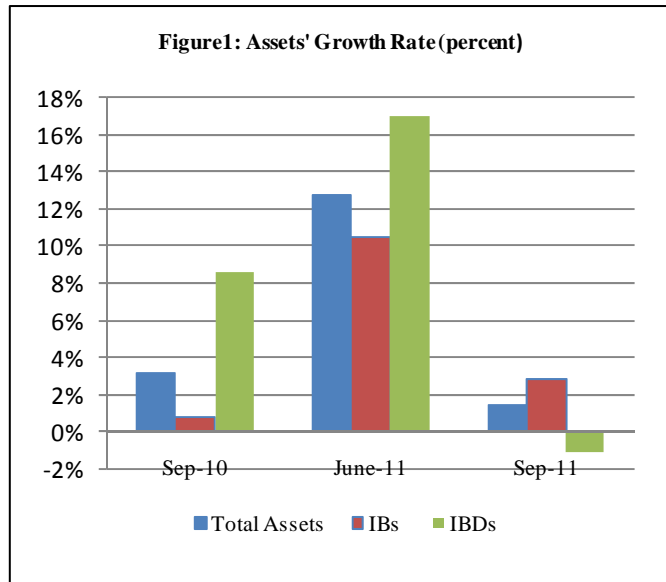
The Islamic Banking Industry (IBI) branch network increased to 841 branches from 799 as at close of the last quarter. By opening 42 branches during the quarter the industry also achieved 62 percent of its planned annual branch expansion plan for CY 2011. In line with the past trend these additional branches are more concentrated in Punjab (23) and Sindh (10) (see **Table 2**) which constitutes 78 percent share of overall network of the industry. Among banks, Meezan Bank Limited has remained prominent in expansion of its network with an increase of twenty branches during the said period. However, the industry still seems reluctant in expanding to second and third tier cities (see **Annexure-III** for details).

Table 2: Province Wise Additional Branches (Sep 2011)

Province	Additional No.	Total No.	Share (percent)
Punjab	23	379	45
Sindh	10	278	33
Khyber Pakhtoonkwa	3	86	10
Balochistan	4	41	5
Gilgit Baltistan	Nil	1	0
FATA	Nil	1	0
Federal Capital	1	44	5
AJK	1	11	1
Total	42	841	100

Asset & Liability Structure

Assets: Assets of IBI reached Rs. 568 billion compared to Rs. 560 billion in last quarter, registering a growth of 2 percent during the quarter under study; the growth is significantly lower than that of the last quarter. It is important to note that assets of full-fledged Islamic Banks (IBs) witnessed a decline in growth rate from 10 percent in the last quarter to 3 percent in the quarter ended Sep 2011, while Islamic Banking Divisions (IBDs) of conventional banks contracted by 1 percent over the period under study in contrast to 17 percent growth in the last quarter (see **Figure 1**) mainly attributable to the category of “other assets”.



Financing: Financing of Islamic banking

Institutions (IBIs) retrenched by almost 6 percent as it dropped to Rs. 177 billion by end of the quarter under study from Rs. 188 billion in the last quarter. This fall in financing is in line with the trend of overall banking industry and also with the usual trend of IBIs. In general the business cycle of most industries including textile (the major share holder of financing of IBIs) enable industries to retire major portion of their financing in third quarter (from July to Sep). This can also be seen by looking at the sector wise financing of IBI; corporate sector that comprises more than 70 percent of the financing recorded negative growth of more than 5 percent. The decline in financing share of industries like textile, sugar, shoes and leather garments (see **Table 3**) etc also support the premise of drop in financing due to nature

Table 3: Financing Concentration - percent share

	Sep-10	Jun-11	Sep-11	Banking Industry (Sep-11)
Chemical and Pharmaceuticals	9.9%	6.9%	7.1%	3.8%
Agribusiness	0.9%	2.8%	2.9%	6.4%
Textile	17.9%	20.4%	16.9%	16.3%
Cement	3.6%	3.4%	4.1%	2.3%
Sugar	2.3%	4.9%	3.2%	2.6%
Shoes and leather garments	1.2%	1.5%	1.2%	0.7%
Automobile and transportation equipment	2.5%	1.8%	1.6%	1.4%
Financial	1.0%	1.4%	1.4%	1.6%
Insurance	0.0%	0.0%	0.0%	0.0%
Electronics and electrical appliances	1.0%	1.3%	1.2%	1.6%
Production and transmission of energy	6.4%	8.5%	10.4%	10.8%
Individuals	18.8%	15.8%	16.5%	11.7%
Others	34.4%	31.4%	33.6%	40.9%
Total	100.0%	100.0%	100.0%	100.0%

of their business cycle.

Mode wise financing (see **Table 4**) indicates that all products showed negative growth other than Istisna which constitute a lower share in overall financing of the industry. Murabaha that constitutes the biggest

	Rupees in billion			Share (percent)		
	Mar-11	Jun-11	Sep-11	Mar-11	Jun-11	Sep-11
Murabaha	86.1	89.6	78.4	45.4	45.0	41.5
Ijarah	23.5	23.4	22.5	12.4	11.7	11.9
Musharaka	5.7	5.5	5.2	3.0	2.8	2.8
Mudaraba	0.3	0.3	0.3	0.1	0.1	0.1
Diminishing Musharaka (DM)	55.7	63.3	62.8	29.4	31.8	33.2
Salam	4.8	4.2	2.8	2.5	2.1	1.5
Istisna	7.6	6.6	7.2	4.0	3.3	3.8
Qarz/Qarz-e-Hasna	0.0	0.0	0.0	0.0	0.0	0.0
Others	5.8	6.2	9.8	3.0	3.1	5.2
Total	189.5	199.2	189.0	100.0	100.0	100.0

share of financing witnessed the highest decline in share of financing; with a share of 41.5 percent by end of the quarter (Sep'2011) from 45 percent in the last quarter ending June 2011. It is important mentioning that in terms of share Diminishing Musharaka (DM) witnessed an increase from 31.8 percent to 33.2 percent however; in absolute number it still registered a decline.

Investment

Investment reached Rs. 236 billion in the quarter ending Sep 2011 from Rs. 231 billion in June 2011 registering a growth of only 2.2 percent in contrast to the growth of 19 percent during the last quarter. The lower growth of investment during the quarter is primarily attributable to non-issuance of GOP Sukuk (see **Figure 2**). However, the available GOP Sukuk in the market remained the major investment avenue for Islamic banking Institutions particularly for IBDs

Asset Quality

Asset quality of the industry

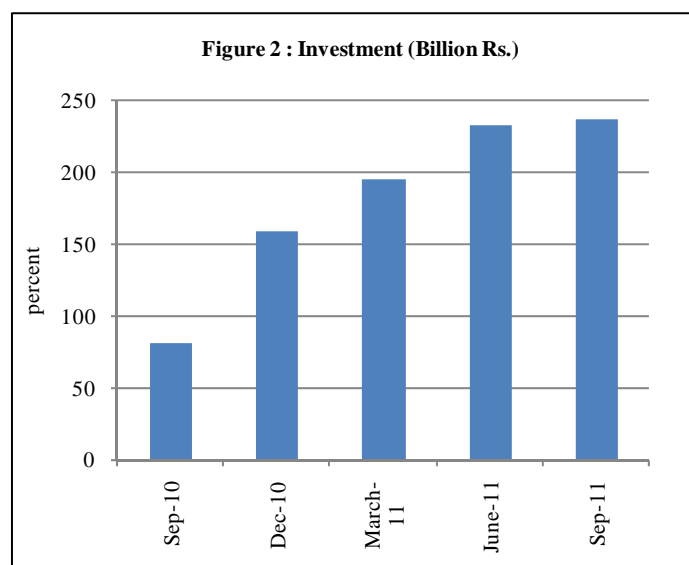


Table 5: Asset Quality Ratios

	Sep-10	Jun-11	Sep-11	Industry
NPFs to Financing	8.4%	7.5%	8.4%	16.7%
Net NPFs to Net Financing	4.1%	3.2%	3.3%	6.4%
Provisions to NPFs	54.1%	60.0%	62.4%	65.8%
Net NPAs to Total Capital	14.9%	14.3%	11.8%	28.6%
Real estate Financing to Total Financing	9.0%	7.4%	7.6%	1.8%
FCY Denominated Financing to Capital	7.2%	15.9%	12.9%	19.6%

deteriorated marginally with non-performing financing (NPF) increasing from Rs. 14.9 billion to Rs. 15.8 billion during the quarter under study (see **Table 5**); the industry witnessed Rs 0.8 billion increase in the category of Substandard while Rs 0.2 billion in category of Doubtful. However, this quarterly rise in NPFs is in line with the quarterly growth of NPLs of the overall banking industry.

The YoY growth rate of 16.8 percent in NPF is lower than that of last quarter, however, the quarterly growth rate (6 percent) is higher than that of the previous quarter indicated by the rising trend of NPFs to Financing as well as the net infection ratio (see **Table 6**). However, both mentioned ratios are still below than the overall industry average (almost half) hinting at the cautious approach of Islamic banks.

Table 6 : Non-Performing Financing(NPFs)

	Rupees in million				
	Growth in %				
	Sep-10	Jun-11	Sep-11	YoY	QoQ*
NPF	13,511.4	14,874.3	15,785.6	16.8	6.1
Provisions	7,305.7	8,926.9	9,847.1	34.8	10.3
Net NPF	6,205.7	5,947.4	5,938.5	-4.3	-0.1
Recovery (year to date)	260.6	635.8	810.1	210.8	27.4
NPA	15,147.1	18,392.4	18,510.9	22.2	0.6
Net NPAs	6,498.8	7,342.4	6,374.5	-1.9	-13.2

Liabilities:

Deposits of the industry reached Rs. 463 billion by end of third quarter (Sep, 2011), increasing from Rs. 452 billion by end of the last quarter (June 2011). However, the growth rate witnessed a decline (see **Table 7**) - both annually (YoY) and quarterly. It is interesting to note that despite the fall in overall growth rate of deposits the category of fixed deposits of customers witnessed a significant rise in its annual and quarterly growth rates from 31.8 percent to 36.5 percent and from 6.3 percent to 7.5 percent

Table 7: Break up of Deposits

	Rupees in million and growth in percent				
	Growth				
	Sep-10	Jun-11	Sep-11	YoY	QoQ*
Deposits	338,216.6	452,127.4	463,065.0	36.9	2.4
Customers	318,255.9	423,234.9	433,690.8	36.3	2.5
Fixed Deposits	128,155.1	162,799.5	174,937.9	36.5	7.5
Saving Deposits	113,229.1	149,970.1	153,161.9	35.3	2.1
Current accounts - Remunerative	-	241.8	493.1	-	103.9
Current accounts - Non-remunerative	74,266.1	107,692.8	102,894.7	38.5	(4.5)
Others	2,605.5	2,530.7	2,203.1	(15.4)	(12.9)
Financial Institutions	19,960.7	28,892.4	29,374.2	47.2	1.7
Remunerative Deposits	19,735.3	28,686.2	29,202.5	48.0	1.8
Non-remunerative Deposits	225.4	206.2	171.7	(23.8)	(16.7)
Currency Wise					
Local Currency Deposits	320,519.1	433,098.4	444,018.3	38.5	2.5
Foreign Currency Deposits	17,697.4	19,029.0	19,046.7	7.6	0.1

respectively. This has also resulted in increasing the share of fixed deposits from 38.4 percent to above 40 percent.

Maturity Gap between Assets & Liabilities

Quarter under review witnessed no change in the trend of asset liability mismatch except for the category ‘maturing after 5 years’ (see **Table 8**) where the positive gap has been transformed into negative gap. The overall trend of asset liability mismatch of IBI remained similar to overall banking industry in all

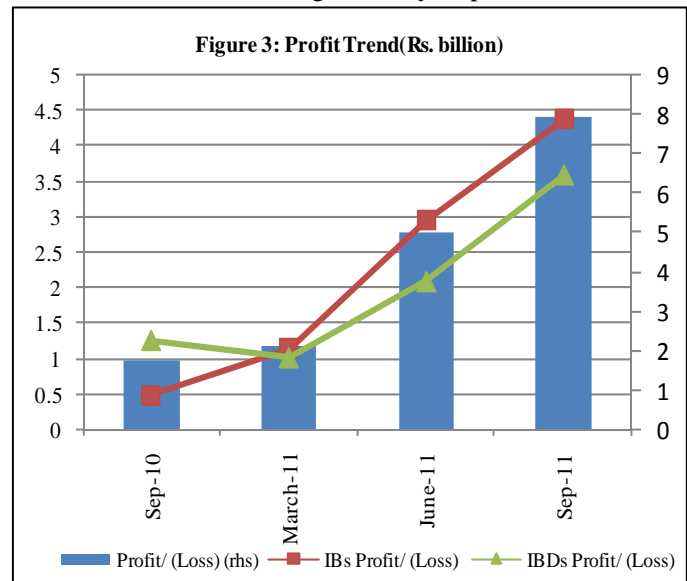
Table 8: Maturity of Assets and Liabilities

	Sep-10	Jun-11	Sep-11	percent share Banking Industry (Sep-11)
Assets				
Maturing upto 3 months	48.0	32.2	31.5	37.7
Maturing from 3 months to 1 yr	17.9	15.3	18.2	27.9
Maturing from 1 yr to 5 yrs	25.0	45.4	44.5	22.6
Maturing after 5 yrs	9.1	7.0	5.7	11.8
Liabilities				
Maturing upto 3 months	52.9	53.2	49.0	43.7
Maturing from 3 months to 1 yr	27.2	26.7	23.5	20.8
Maturing from 1 yr to 5 yrs	14.7	15.4	20.6	23.9
Maturing after 5 yrs	5.3	4.7	7.0	11.6
Gap--asset share minus liability share				
Maturing upto 3 months	(4.8)	(21.0)	(17.4)	(6.0)
Maturing from 3 months to 1 yr	(9.3)	(11.4)	(5.2)	7.1
Maturing from 1 yr to 5 yrs	10.4	30.1	23.9	(1.3)
Maturing after 5 yrs	3.7	2.3	(1.3)	0.2

categories except ‘maturing from 3 months to 1 year’ where overall banking industry depicted a rise in gap while IBI witnessed a decline from negative gap of 11.4 percent to negative 5.2 percent.

Earning & Profitability

The profit of Islamic banking industry reached Rs. 8 billion by end of the quarter under study (see **Figure 3**) showing growth of over 58 percent. The growth in profit during the said quarter is relatively lower than the growth rate of the last quarter (100 percent). However, the significantly higher growth rate of the last quarter can be associated to the base effect. It is noteworthy that the quarterly growth rate of profit of conventional banks having Islamic banking branches is significantly higher than the



growth rate of full fledged Islamic banks. The share of full fledged banks in overall profit of IBI though declined marginally over this quarter still constitutes major share (55 percent share) (see **Figure 3**) of overall profit of the industry.

IBI continued its positive trend of earning as indicated by the rising trend in return on assets (ROA) and return on equity (ROE) (see **Table 9**), both these ratios though didn't show any significant change over the quarter under review for the overall banking industry. It is also worth noticing that for IBI 'Net Mark-up/Profit income to Gross income' indicated a decline while 'Non-Mark-up/Profit income to Gross income' showed an upward trend which is in contrast to overall banking industry norms.

Table 9: Earnings and Profitability	Sep-10	Jun-11	Sep-11	Banking Industry (Sep-11)
Net Income to Total Assets(ROA)	0.6%	1.6%	1.7%	1.4%
Return on Equity (ROE)	5.3%	16.5%	17.6%	14.2%
Net Mark-up/Profit income to Gross Income	80.0%	82.6%	81.9%	76.5%
Non- Mark-up/Profit Income to Gross Income	20.0%	17.4%	18.1%	23.5%
Trading & Fx Gains/(Losses) to Gross Income	8.3%	5.3%	4.9%	7.3%
Operating Expense to Gross Income	73.9%	60.9%	58.6%	51.0%
Personnel Expense to Operating Expense	31.4%	36.1%	34.8%	37.3%
Spread Between Financing & Deposit Rate	7.7%	8.8%	8.4%	6.7%

Events and Developments at IBD

Awareness Program on Islamic Banking:

Held at Fatima Jinnah Women University Rawalpindi on October 18, 2011.

DFSD SBP BSC Rawalpindi organized an awareness program on Islamic Banking at Fatima Jinnah Women University Rawalpindi on October 18, 2011. Mr. Munir Ahmed, Joint Director, Islamic Banking Department (IBD) was the chief guest and key speaker at the occasion.

The objective was to create awareness about the basic issues in Islamic banking and to remove misconceptions about the ongoing Islamic Banking in Pakistan. The program was attended by more than 100 students and faculty members of the university.

Mr. Munir Ahmed gave a detailed presentation on various aspects of Islamic Banking with an Q & A session at the end.

Shariah Advisors' Forum Meeting:

Held on September 08, 2011 at LRC, SBP – Karachi

Shariah Advisor's forum meeting was held on 08th September, 2011 at State Bank of Pakistan, I. I. Chundrigar Road, Karachi. The main agenda item was *Presentation and discussion on "Annual Report of Shariah Advisors – Contents and Responsibilities"*.

Mr. Saleem Ullah, Director Islamic Banking Department (IBD), SBP, briefed participants about the back ground of the presentation and informed that the discussion is aimed at identifying the areas where more clarity in the role and responsibilities of Shariah Advisors is needed and to develop recommendations for removing confusions in the role of Shariah Advisors. He emphasized that Shariah Advisor's role and responsibility is critically important for Islamic banking Institutions (IBIs) as all stakeholders especially general public largely rely on them for Shariah permissibility of products and services of IBIs.

Mr. Omar Mustafa, Partner – E&Y Pakistan gave a detailed presentation and focused on the key role and responsibilities of Islamic bank's management and Shariah Advisors in ensuring Shariah compliance including the significance of Shraiah audit. It was discussed that IBIs need to strengthen their overall Shariah compliance mechanism.

Islamic Agricultural Financing for Farm/Crop Production Purposes under Salam:

Islamic Banking Department (IBD) and Agricultural Credit & Microfinance Department (AC&MFD) jointly developed a model product based on 'Salam' to meet financing needs of production finance (working capital) needs of country's farming community. The product was issued vide AC&MFD Circular No. 3 of October 18, 2011. The model product developed, in consultation with all stakeholders, will facilitate Islamic Banking Institutions (IBIs) in improving the access of agricultural Islamic financing

to the farming community. The product covers the Shariah related aspects as well as business cycle and financing requirements of farm/ crop production activities.

The product based on ‘Salam‘ i.e. sale of agri. produce against full payment in advance but deferred delivery on a specified future date, will give necessary flexibility to farmers to use funds to meet farming input requirements. IBIs may adopt the model product in the present form or with some adjustments to suit their organizational & operational needs and market characteristics, subject to compliance with SBP regulations and approval from their Shariah Advisors. IBIs have been advised to ensure that their relevant staff possess the requisite knowledge and expertise about the product. In this regard they should also launch awareness campaigns through electronic & print media, seminars, workshops, etc to ensure that their clients/ farmers are fully educated about the product and familiar with the requirements like documentation, loan limit, process flow/ procedure, etc.

Islamic Banking News and Views

News

Albaraka, Turkey Unit to Sell \$500 Million in Sukuk in 2011

Albaraka Banking Group BSC, Bahrain’s biggest publicly traded Islamic lender, and its unit in Turkey may raise a total \$500 million in sukuk this year, Chief Executive Officer Adnan Ahmed Yousif said.

Albaraka Turk Katilim Bankasi AS is in the process of hiring banks to manage the sale of about \$200 million in Islamic bonds by November. The parent bank may sell about \$300 million by the end of the year.

Source: <http://www.businessweek.com/news/2011-09-25/albaraka-turkey-unit-to-sell-500-million-in-sukuk-in-2011.html>

Bahrain plans \$1bn sovereign Islamic bond

Bahrain is planning to issue a \$1 billion sovereign Islamic bond and has mandated three banks for the proposed sale, banking sources said.

BNP Paribas, Citigroup and Standard Chartered have been appointed to manage the issue, the bankers with knowledge of the move said, although they gave no idea as to when the issue would happen.

Source: <http://arabnews.com/economy/article507403.ece>

QIIB eyes benchmark Islamic bond

Qatar International Islamic Bank (QIIB) is planning to issue a benchmark-sized Islamic bond and has hired banks to arrange the sale. The Islamic lender appointed QNB Capital, the investment banking arm of Qatar National Bank , Standard Chartered and HSBC to issue a benchmark sukuk, or Islamic bond,

Benchmark-sized offerings are understood to be at least \$500 million in size. The sukuk is believed to be US dollar-denominated and could be issued by the end of this year or in early 2012.

Source: http://www.tradearabia.com/news/BANK_205666.html

'Sukuk market proved resilient in the face of the crisis'

NCB Capital, Saudi Arabia's largest investment bank and leading GCC wealth manager, discussed the future of Islamic funds industry at the 7th World Islamic Funds Conference held recently in Bahrain under the theme "Global and Regional Economic Outlook: Assessing the Impact on the Performance of Islamic Funds."

Addressing the conference, NCB Chief Economist Jarmo Kotilaine said: "Strong growth in Islamic banking continues a pace," noting that global Islamic banks' assets have increased considerably from \$145 billion in 2002 to \$1,033 billion in 2010.

Source: <http://arabnews.com/economy/article511023.ece>

Trade finance to propel Islamic banking industry

Islamic trade finance has benefited from shifting preferences towards Sharia-compliant banking and could serve as one of the key growth drivers to help the nearly US\$1-trillion Islamic finance industry double in size, according to the World Islamic Economic Forum Foundation.

Source: http://www.businesslive.co.za/southafrica/sa_markets/2011/10/18/trade-finance-to-propel-islamic-banking-industry

SBP urges Islamic banks to diversify investment portfolios

The State Bank of Pakistan (SBP) has stressed upon the Islamic banks to diversify their investment portfolios by enhancing financing to Small and Medium Enterprises (SMEs), agriculture, housing finance and microfinance sectors of the economy.

Addressing as the chief guest at a two-day first World Islamic Finance Summit 2011 on Wednesday, SBP Deputy Governor Muhammad Kamran Shahzad said that Islamic banks cannot only increase their depth and breadth, but also contribute to higher financial inclusion levels in the country by targeting these underserved sectors of the economy.

Source: <http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=68789&Cat=3>

Articles/Views

It's all about Syariah

Source: <http://www.theborneopost.com/2011/09/11/it%E2%80%99s-all-about-syariah/>

Solid fundamentals

Source: <http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aid=2780&cat=BME&in=132>

Islamic banking: Panacea for global financial crisis

Source: <http://tribune.com.ng/index.php/eyes-of-islam/28623-islamic-banking-panacea-for-global-financial-crisis>

Islamic banking — some regulatory insights

Source: <http://main.omanobserver.om/node/69604>

SBP and shari'a compliant money

Source: <http://www.pakistantoday.com.pk/2011/10/sbp-and-shari%E2%80%99a-compliant-money/>

Islamic banking as a policy tool

Source: <http://www.pakistantoday.com.pk/2011/10/islamic-banking-as-a-policy-tool/>

Islamic Foundations: a new financial model

Source: <http://www.pakistantoday.com.pk/2011/10/islamic-foundations-a-new-financial-model/>

Book Review:

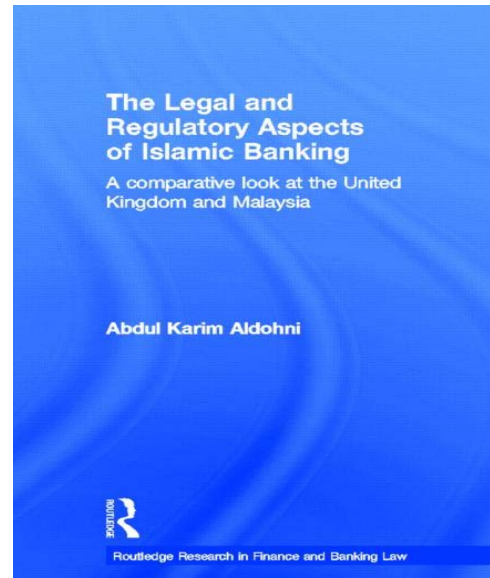
The Legal and Regulatory Aspects of Islamic Banking

A comparative look at the United Kingdom and Malaysia

Author: Abdul Karim Aldohni

Published by: Routledge, Taylor & Francis Group, London & New York

ISBN: 978-0-415-55515-9



The book “**The Legal and Regulatory Aspects of Islamic Banking**” focuses on the existing international and British banking regulatory frameworks and tries to examine their impact on Islamic banking sector.

In terms of structure, following introductory chapter, the book describes historical and ideological background of Islamic banking in chapter two. In particular the chapter discusses the growth of Islamic banking in the Western world with specific reference to the United Kingdom. The chapter concludes by describing religious, economic and ethical aspects of Islamic banking. In the following chapter, author presents legal position of Islamic banks by drawing an analytical comparison between the English and Islamic legal system.

Chapter four presents the legal description and classification of Islamic banks under the British law and examines the nature of Islamic banking in comparison to commercial and investment banking. Following discussion on theoretical issues, the book shifts arguments towards operational aspects of Islamic banking. Establishment of Islamic banks in the light of British company law is analysed by shedding light on the special structure of Islamic banks and the presence of Shariah Supervisory board along with directors’ board in chapter five. The chapter also provides insight into how legal concerns arising from the Islamic financial contracts that have been dealt by the English courts.

The subsequent chapter provides an overview on the regulatory and supervisory system of banking sector in the United Kingdom and inspects key prudential methods used by regulators. The chapter also presents a brief discussion on international aspects of banking regulations and provides a brief introduction of Basel Core Principles and Basel II, which are adopted by UK banking regulatory system.

The impact of prevailing conventional banking regulations on the Islamic banking industry is discussed in seventh chapter. This part of the book tries to draw a rationale for regulations on Islamic banking despite having a different nature than their conventional counterparts. Consumer protection, public awareness and crime prevention are some of the issues that form part of the discussion. The chapter concludes by exploring compatibility of practices of Islamic banks with Basel Core Principles and Basel II.

After providing a detailed analysis on legal and regulatory aspects of Islamic banking in the United Kingdom, the author provides an insight into the Malaysian experience of Islamic banking sector. In particular, the author emphasises on Malaysian approach to dealing with regulatory issues and key differences between the Malaysian and UK experience with regard to Islamic banking. The chapter

concludes by highlighting a few leading legal and regulatory issues regarding Islamic finance in Malaysia.

The author has been able to provide a comprehensive coverage on theoretical and practical issues of the legal and regulatory aspects of Islamic banking. The book can therefore be termed a valuable addition to the existing Islamic banking literature and can serve as a useful guide for both practitioners and students of Islamic banking and finance.

Country Model: Sudan

Islamic financial services began in Sudan in 1977 with the establishment of Faysal Islamic Bank, the first full-fledged Islamic bank in the country. Since then Islamic financial services have witnessed significant growth in Sudan and the country is generally considered as one of the leading countries providing Islamic finance in the African region.

According to Central Bank of Sudan Annual Report 2010, there are 39 banks operating in Sudan. Amongst various modes of financing, Murabaha remains the dominant mode constituting more than half of the financing.

Historical Development:

Following the establishment of Faysal Islamic Bank, three Islamic banks began their operations by 1983. In the same year under strong political and legislative will, process of adopting a purely Islamic banking system initiated in the country (see **Table 1** for details of Historical Development of Islamic Finance Industry in Sudan). It took nearly a decade for the country to be completely transformed into Islamic banking system following the Banking Law 1992 that required all financial transactions to be Shariah compliant.

Table 1: Historical Development of Islamic Finance Industry in Sudan

Year	Development
1977	Establishment of first Islamic Bank (Faysal Islamic Bank)
1983	Initialization of Process of Adopting a purely Islamic Banking System
1992	Banking Law; Complete Islamization of Financial system
1993	Establishment of High Shariah Supervisory Board (HSSB)
1999	Issuance of First Islamic Bonds
2002	Central Bank of Sudan Act
2003	Law of Insurance and Takaful
2006	Amendment in Banking Law following Comprehensive Peace Agreement (CPA) in 2005
2008	First Sovereign Sukuk of USD 147 million issued

Role of Central Bank of Sudan:

The Central Bank of Sudan has played an active role in promoting the process of Islamization of banking industry in the country. The first step in this direction was drafting of Banking Law 1992. Later, the central bank established the High Shariah Supervisory Board (HSSB) in 1993 (for details see below). The Central Bank of Sudan introduced financial reforms in the country over the period; 1999-2002, according to which Basel requirements, aligned with the Shariah principles, were introduced in the country. In 2002 the Central Bank of Sudan Act was enforced that categorically required all banking system to act in accordance with Islamic Shariah. However, a comprehensive peace agreement between the Northern and Southern Sudan in 2005 amended the Central Bank of Sudan Act and subsequently in 2006 it was agreed that the Banking industry in the Northern region would continue to work under Islamic Shariah whereas the Southern region was allowed to set up conventional banking.

High Shariah Supervisory Board (HSSB):

In 1993, High Shariah Supervisory Board (HSSB) was established in the country to oversee compliance and facilitate the Shariah compliant operations of all banks. The board comprises of Islamic scholars, bankers and economists. The HSSB remains the supreme authority with regards to all Shariah matters of Islamic banking industry in the country. However, rules for all Islamic banks are set by the Bank of Sudan (central bank) while individual Shariah boards of banks act to monitor day to day activities. Most members of individual Shariah boards of banks are also members of HSSB. The HSSB acts as an appeal authority for disputes between Islamic banks, Islamic banks and the Bank of Sudan, and an Islamic bank and its customers.

Liquidity Management:

Following the Islamization of banking sector, financial certificates complying with Islamic financial principles are issued on behalf of the government. The first Islamic bond of this kind was issued in 1999 and to date Government Musharaka Certificates (GMCs), also known as Shahama bonds, are used by the state to borrow money in domestic markets. Apart from GMCs other Islamic bonds including Government Investment Certificates (GICs) and Central Bank of Sudan Ijarah Certificates (Shihab) are also used for liquidity management. Sudan is also active in issuing Sukuk and the first sovereign Sukuk of USD 147 million were issued in 2008.

Insurance and Takaful:

History of Takaful industry in Sudan dates back to 1977 when Faisal Islamic Bank set up Islamic Insurance Company of Sudan. In 1992, the state passed a ruling which required all insurance operators in Sudan to comply with Shariah principles. However, it took another eleven years for the Law of Insurance and Takaful to be passed in the country and at present a fully Islamized insurance sector is working in the country.

Conclusion:

In general, from the above discussion it can be concluded that sincere efforts have been made in Sudan for converting the entire financial structure into an Islamic one supported by favorable legal, regulatory and Shariah compliance environment and has thus enabled Sudan to become a regional leader in Islamic banking and finance.

Note: Information in this section has been obtained from Global Islamic Finance Report 2011 and Central Bank of Sudan website.

Islamic Financing Mode in Focus

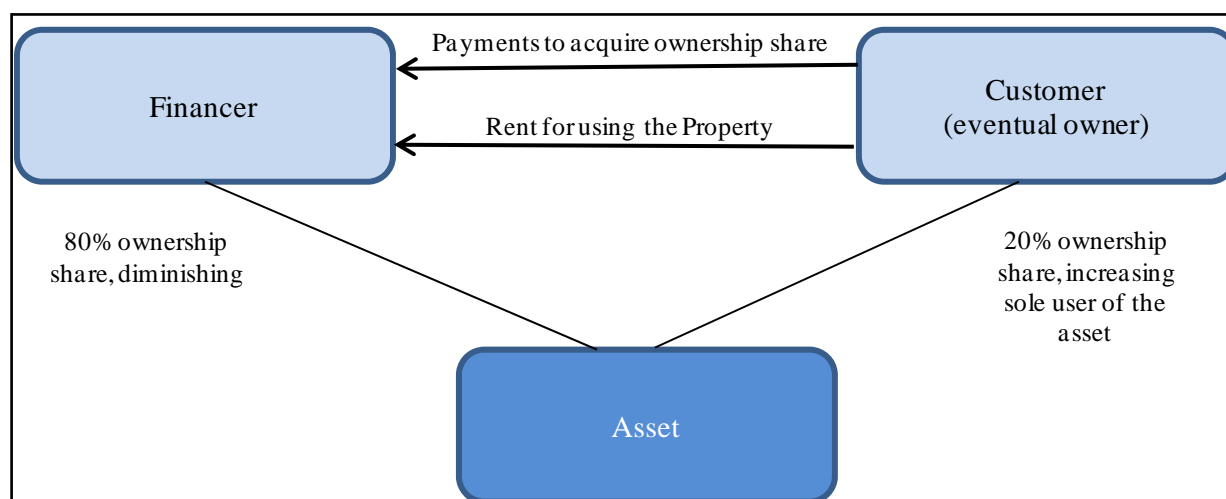
An Introduction to Diminishing Musharaka (Shirakt-ul-Milk)

Diminishing Musharaka is a mode of financing, in which a financier and client share the ownership of a tangible asset in an agreed proportion and client undertakes a promise to buy equity share of financier on a periodic basis until the title of asset is completely transferred to the client. Diminishing Musharaka mode is generally used for financing fixed assets such as house, auto, plant and machinery financing by Islamic Banks throughout the world. In Pakistan around 33 percent of the overall Islamic banking financing is Diminishing Musharaka based and it is currently the second most utilized mode of finance after Murabaha (for details see section on **Industry – Progress and Market Share**).

Diminishing Musharaka Structure:

The classic Diminishing Musharaka arrangement consists of the following steps and is illustrated in **Figure** below:

1. Customer and financier enter into a Diminishing Musharaka contract. They contribute capital and acquire asset on co-ownership basis. The asset is divided into a number of units.



2. Financer leases his share in the asset to customer and customer in response pays financier the rent for the lease.
3. Customer promises to acquire the financier's share in the asset over an agreed period of time through periodic payments. Similarly, the financier also promises to sell its share in asset to the customer. The amount of rent payable to the financier decreases proportionately as the customer secures additional units of the asset. After all the units are acquired by the customer, the title of the asset is transferred into the name of the customer.

A Diminishing Musharaka contract thus consists of three sub-contracts i.e. co-ownership between customer and financier, leasing by financier of its share in the asset to customer and selling by financier of its share to customer. Accordingly separate agreements/contracts are entered into at different periods in

such a manner and sequence that each agreement/contract is independent of the other. This is to ensure that each agreement is a separate transaction.

It is pertinent to note that it is essential for a Diminishing Musharaka contract to clearly identify proportionate share of each co-owner in terms of investment. Moreover, details regarding additional expenses or loss need to be clearly identified and mentioned in the Diminishing Musharaka contract.

Purchase Price of Units of Asset:

The purchase price for each unit is generally agreed upfront in the Diminishing Musharaka agreement. In practice two arrangements are commonly used:

- The price of each unit is equal to its original cost paid by the financier. Thus the financier does not benefit/lose from increases/decrease in value of asset.
- The price of each unit is equal to the market value of that fraction of asset on the date when customer purchases the unit. Thus financier is also benefitting/losing from any increase/decrease in value of the asset.

Criticism:

Diminishing Musharaka has been criticized by some scholars because of certain issues underlying in this mode of financing. They include:

- It is generally agreed by scholars that the purchase price of a unit can be predetermined if Musharaka contract is *shirakat al-milk* (joint ownership of an asset but not for commercial purposes). However, in reality bank enters into the contract for commercial purposes; hence such pre-determined price has been questioned by some critics.
- Another important issue is the promise from customer to buy share of the financier gradually until he owns whole asset. Islamic scholars have two opinions in this regard as to whether fulfilling this promise is mandatory or recommended. However, the International Fiqh Academy under OIC in its rulings has decided that a promise is legally binding. Therefore, if promise is not fulfilled without a valid cause, compensation must be paid by customer to financier.
- The fluctuation of rental price of asset is another issue that Diminishing Musharaka has to face. Usually, rental price increases with the passage of time and thereby creates difficulties for customers.

Despite the above mentioned criticism, International Fiqh Academy of OIC, and scholars in general have recognized Diminishing Musharaka as a permissible contract under Islamic Shariah. However, scholars suggest some principles and guidelines that need to be adhered to, so that this contract does not exceed the boundary of Shariah and become similar to interest based contracts. The principles that need to be followed include:

1. The goods must exist. Hence asset which is not physically present or has been acquired on loan is not allowed for having a transaction.
2. Shariah advisors or Shariah Advisory board at banks must have the right to monitor the contract.

3. The contract of partnership and the contract of sale should be done separately, and should remain independent of each other
4. A binding promise can be taken from one partner to purchase the share of the other partner gradually.

Conclusion:

Diminishing Musharaka is increasingly becoming a popular mode for financing fixed assets in Islamic banking. Despite facing criticism from some scholars, the above mentioned mode has generally been cited as a permissible contract under Islamic Shariah and Diminishing Musharaka based financing represents a significant portion of Islamic Finance industry.

Sources:

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Annexure

		Annexure: I
<i>Islamic Banking Branch Network</i>		
(As of September 30, 2011)		
Type	Name of Bank	No of Branches*
Islamic Banks	Al Baraka Islamic Bank	87
	BankIslami Pakistan Limited	70
	Dawood Islamic Bank Limited	42
	Dubai Islamic Bank Pakistan Ltd	73
	Meezan Bank Ltd	252
		524
Islamic Branches of Conventional Banks	Askari Bank Limited	29
	Bank Al Habib Ltd	11
	Bank Alfalah Ltd	82
	Faysal Bank Limited	43
	Habib Bank Ltd	22
	Habib Metropolitan Bank	4
	MCB Bank Ltd	15
	National Bank of Pakistan	8
	Soneri Bank Ltd	6
	Standard Chartered Bank	15
	The Bank of Khyber	22
United Bank Ltd	11	
Sub Total		268
Sub Branches	Al Baraka Islamic Bank	2
	Askari Bank Limited	2
	BankIslami Pakistan Limited	32
	Dawood Islamic Bank Limited	8
	MCB Bank Ltd	2
	The Bank of Khyber	3
Sub Total		49
Grand Total		841

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

Province wise Break-up of Islamic Banking Branch Network

(As of September 30, 2011)

Type	Bank Name	Azad Kashmir	Balochistan	FATA	Federal Capital	Khyber Pakhtun khwa	Gilgit-Baltistan	Punjab	Sindh	Grand Total
Islamic Banks.	Albaraka Islamic Bank	1	3		4	9		42	28	87
	BankIslami Pakistan Limited	1	8		2	5	1	30	23	70
	Dawood Islamic Bank Limited		1		2	2		17	20	42
	Dubai Islamic Bank Pakistan Limited	1	5		4	3		35	25	73
	Meezan Bank Limited	4	6		13	21		122	86	252
IB. Total	7	23		25	40	1	246	182	524	
Islamic Branches of Conventional Banks	Askari Bank Limited		2		1	5		14	7	29
	Bank AL Habib Limited		1			1		3	6	11
	Bank Alfalah Limited		3		6	3		50	20	82
	Habib Bank Limited	2	1		2	2		9	6	22
	Habib Metropolitan Bank Limited							1	3	4
	MCB Bank Limited		1		1	1		6	6	15
	National Bank of Pakistan	1				1		4	2	8
	Soneri Bank Limited		1		1	1		1	2	6
	Standard Chartered Bank(Pakistan)		1		1	3		4	6	15
	The Bank of Khyber		2	1		14		3	2	22
	United Bank Limited		1		1	1		4	4	11
	Faysal Bank Limited		2		1	11		20	9	43
SAIBBs Total	3	15	1	14	43	-	119	73	268	
Sub Branches	Albaraka Islamic Bank				1				1	2
	Askari Bank Limited				1				1	2
	BankIslami Pakistan Limited	1	3		3	2		9	14	32
	Dawood Islamic Bank Limited							3	5	8
	MCB Ban Limited							1	1	2
	The Bank of Khyber					1		1	1	3
Sub Branches Total	1	3		5	3	-	14	23	49	
Grand Total	11	41	1	44	86	1	379	278	841	

District wise Break-up of Islamic Banking Branch Network

(As of September, 30, 2011)

S. No	Province	Cities	No of Branches	S. No	Province	Cities	No of Branches	
1	Sindh	Badin	1	42	Khyber Pakhtunkhwa	Abottabad	11	
2		Dadu	2	43		Banu	2	
3		Hyderabad	21	44		Charsadda	2	
4		Karachi	229	45		Chitral	1	
5		Larkana	1	46		Dera Ismail Khan	4	
6		Matiari	1	47		Hangu	1	
7		Mirpur Khas	3	48		Haripur	4	
		Naushero Feroze	1					
8		Nawabshah	5	49		Kohat	3	
9		Sanghar	4	50		Malakand	1	
10		Sukkur	8	51		Mansehra	6	
11	Tando Allahyar	2	52	Mardan	6			
Sindh Total			278	53		Nowshera	4	
12	Punjab	Attock	6	54	Balochistan	Peshawar	33	
13		Bahawalnagar	4	55		Swabi	3	
14		Bahawalpur	4	56		Swat	2	
15		Chakwal	3	57		Tank	1	
16		Dera Ghazi Khan	3	58		Upper Dir	2	
17		Faisalabad	36	KP Total		86		
18		Gujranwala	12	59		Chagi	1	
19		Gujrat	16	60		Gawadar	1	
20		Hafizabad	2	61		Kila Abdullah	2	
21		Jhang	3	62		Killa Saifullah	2	
22		Jhelum	5	63		Lasbela	1	
23		Kasur	3	64		Loralai	3	
24		Khanewal	6	65		Pishin	1	
25		Khushab	4	66		Quetta	29	
26		Lahore	140	67		Zhob	1	
			Balochistan Total			41		
27		Lodhran	1	68		Gilgit-Baltistan	Gilgit	1
28		Mandi Bahauddin	1	Gilgit-Baltistan Total			1	
29	Mianwali	1	70	FATA	Khyber Agency	1		
30	Multan	28	FATA Total			1		
31	Muzaffargarh	3	71	Federal Capital	Islamabad	44		
32	Okara	3	Federal Capital Total			44		
33	Pakpattan	2	72	Azad Kashmir	Mirpur AJK	8		
34	Rahim Yar Khan	9	73		Muzaffarabad	3		
35	Rawalpindi	44	Azad Kashmir Total			11		
36	Sahiwal	4	Grand Total			841		
37	Sargodha	11						
38	Sheikhupura	4						
39	Sialkot	15						
40	Toba Tek Singh	2						
41	Vehari	4						
Punjab Total			379					

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