Islamic Banking Bulletin

December 2012

Islamic Banking Department
State Bank of Pakistan

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Executive Director's Speech

Welcome Address

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Executive Director (Development Finance Group and Banking Policy Review Group)
State Bank of Pakistan,
One Week Training on "Training of Trainers"
(Jointly Organized by IRTI & SBP)
December17- 23, 2012.

Ladies and gentlemen, I am delighted to welcome you all to this one week training program on Islamic finance and wish you a very pleasant stay in Islamabad. I would also like to thank the Islamic Research and Training Institute (IRTI) team for holding this training activity in Pakistan. 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 capacity building initiatives . We hope that this program will enable the participants to have a better understanding of fundamentals of Islamic banking, the regulatory environment and major challenges that may hinder its growth momentum. The programs seem very focused and is very relevant with the objective of training of trainers as it covers key issues with the potential role of Islamic finance towards the overall economic growth of any country.

Ladies and Gentlemen! Global Islamic finance has witnessed substantial growth over the last four decades. Demand for Islamic finance is not just confined to Muslim countries but many Western countries are also acknowledging the significance of Islamic finance as an alternate and viable financing mechanism particularly after the resilience shown by the industry during the recent financial crisis. The asset backed nature of Islamic financial transactions, coupled with prohibition on speculative activities makes Islamic finance a more stable and prudent system than its conventional counterpart.

Pakistan is among the few countries where the process of Islamisation of the financial system started during the decade of 70's. We tried to transform the whole banking sector into Shariah compliant system in 1980s but had a limited success. In 2001, we adopted a gradual approach that allowed the parallel banking regime where both Islamic and conventional banks can co-exist and operate in the country. This approach has rather been successful in promotion of Islamic banking in the country.

The existing framework allows three types of Islamic banking institutions in the country ie i) Full fledged Islamic banks, ii) Islamic banking subsidiaries of conventional banks and iii) Islamic banking branches (IBBs) of conventional banks. A comprehensive Shariah compliance framework has been introduced that includes a) Shariah Board at the Central Bank, which is the apex Shariah Body in the country for Islamic banking institutions, b)the Shariah Advisor at bank's level to be appointed in accordance with the State Bank of Pakistan's Fit and Proper criteria with the responsibility to ensure that bank's operations are in conformity with Shariah, c) mandatory internal Shariah audit, and d) periodic Shariah inspections by the Central Bank.

Since its re-launch in 2001, the Islamic banking industry has gradually increased its share and presently constitutes above 8 percent of the overall banking system in Pakistan. There are currently 5 full fledge Islamic banks and 13 conventional banks having Islamic banking branches with a network of 977 branches across the country. The industry has been maintaining strong growth momentum with over 30 percent average annual growth during last eight 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 all initiatives for promotion of Islamic finance that has remained an important component of its strategic goals. Besides developing a supportive regulatory and supervisory framework the central bank is actively engaged in promotion 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. 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.

Ladies and Gentlemen; Besides lack of awareness and HR capacity constraints, the industry in Pakistan as elsewhere faces issues like low product diversification and limited avenues for liquidity management that need to be addressed for maintaining the growth momentum.

Since its present phase beginning in the decade of 90s, Islamic Finance industry has had limited products that have predominantly been trade based. While there are risks like moral hazards and adverse selection associated with participatory based products of Musharaka and Mudaraba, efforts need to be undertaken for building necessary institutional capacity to gradually improve the size of such portfolio, which presently remains very low. Further, the Islamic banks are having limited exposures in non-traditional sectors like agriculture and SMEs largely due to high risk perception and low penetration in rural areas. While the overall risk profile of these sectors may be higher, the growth potential is enormous provided that adequate HR and risk management capacity is created to build exposure in such sectors.

In terms of liquidity management, Sukuk issuance over the years has provided an attractive investment avenue to the industry for managing excess liquidity. However, there is a dire need for active secondary market of Sukuk as well as Islamic discount window enabling Islamic banking industry to be efficient and effective with their liquidity Management. Comprehensive Liquidity Management Framework is at an advanced level of development at the central bank and will soon be issued that is expected to give further boost to the industry.

Here I would also like to highlight that the State bank of Pakistan is also focused on safeguarding the interests of depositors along with stability of financial sector while customizing the regulatory framework for Islamic Banking industry. In this regard the recently issued Instructions for Profit & Loss Distribution and Pool Management for Islamic bank Institutions is of paramount importance.

Ladies and Gentleman: Islamic banking has established its identity in these challenging times. It is however essential to develop a comprehensive and well established Islamic financial system consisting of a wide range of products and services; a good legal system, adequate financial infrastructure with competitive tax structures, low cost of doing business and high standards of business ethics. This would however, require strong commitment from policy makers as well as the banks’ management and significant investment in human resources. Innovation remains imperative for growth of the industry that requires skilled HR. In this respect programs like this are step in the right direction but will have to be significantly intensified.

In the end, I would like to thank all the speakers and participants in particular the Islamic Research and Training Institute (IRTI) team for coming here and hope the training activity will prove to be a good learning experience.

Islamic Banking Industry- Progress & Market Share

Overview

Asset base of the Islamic banking industry (IBI) continued to grow during the last quarter of CY 2012 as it reached Rs 837 billion compared to Rs 742 billion in the previous quarter. Similarly deposits of Islamic banking industry (IBI) also registered positive growth during the quarter under review to reach Rs 706 billion (see **Table 1**). Consequently market share of Islamic banking assets and deposits in overall banking industry increased to 8.6 percent and 9.7 percent respectively by end December 2012. In terms of profitability, profit of Islamic banking industry remained Rs 10 billion during the last quarter of CY 2012. As a positive development, both Non-performing finances (NPFs) to financing ratio as well as Net non-performing assets to total capital ratio witnessed decline during the quarter ending December 2012.

Table 1: Industry Progress and market share

	Industry Progress			Growth (QoQ)			Share in Industry		
	Dec-11	Sep-12	Dec-12	Dec-11	Sep-12	Dec-12	Dec-11	Sep-12	Dec-12
Total Assets	641	742	837	12.8%	4.3%	12.8%	7.8%	8.1%	8.6%
Deposits	*521*	628	706	12.5%	4.2%	12.5%	8.4%	9.3%	9.7%
Net Financing & Investment	*475*	*571*	*626*	28.8%	8.2%	23.0%	7.4%	7.8%	8.1%
Total Islamic Banking Institutions	*17*	*18*	*18*	–	–	–	–	–	–
Total No. of Branches*	*886*	*977*	*1097*	–	–	–	–	–	–

Source: Quarterly Unaudited Accounts

**number includes sub-branches*

IBI Network Expansion

Islamic Banking Industry branch network continued to expand and crossed 1000 branches mark during September to December quarter 2012 (see **Table 2**). In total 120 additional branches were added to Islamic banking branch network during the quarter. These additional branches were established across all provinces and 3 new districts Ghotki, Layyah and Shangla were added in the list of districts having Islamic banking branches (see **Annexure III** for details). Encouragingly provinces like Baluchistan and AJK, where no additional branch was opened in the previous quarter, witnessed setting up of branches in the quarter under review. It s important to note that 211 new branches were opened in CY 2012 which is higher compared to 135 branches opened in CY 2011.

Table 2: Province Wise Additional Branches (December 2012)

Province	Additional Number	Total Number	Share (percent)
Punjab	47	476	43.4
Sindh	38	369	33.6
Khyber Pakhtoonkhawa	16	120	10.9
Baluchistan	7	51	4.6
Gilgit Baltistan	2	4	0.4
FATA	1	4	0.4
Federal Capital	7	60	5.5
AJK	2	13	1.2
Total	**120**	**1097**	**100.0**

Asset & Liability Structure

Asset: Islamic banking industry assets grew by 12.8 percent to reach Rs. 837 billion by end December 2012 from Rs. 742 billion in the previous quarter and from Rs 641 billion as at end December 2011 (YoY growth was 30.5 percent). In terms of market share, share of Islamic banking assets in overall banking industry increased to 8.6 percent from 8.1 percent in the previous quarter, reflecting relatively better growth in assets of Islamic banking industry compared to assets of overall banking industry[1].

The two major components of assets i.e. investments and financing, both registered positive growth during last quarter of CY 2012 though growth in financing (17.5 percent) was higher than the growth in investments (5.5 percent). It is important to note that this is the first time since March 2010 that the growth in financing is greater compared to growth in investments (see **Figure 1**). This is against the trend witnessed in previous quarters where investment has witnessed continuous upsurge (due to availability of GoP Ijara Sukuk) compared to relatively moderate increase in financing. Though financing generally gains pace during last quarter which among others is attributable to the nature of business cycle of most industries; this development is still encouraging considering the cautious approach adopted by Islamic banks in financing to private sector over the last few quarters. Another reason for relatively slower growth in investments is that no new Sukuk was issued during the quarter under review. Consequently share of financing in overall asset portfolio increased during the quarter under review to 27.6 percent from 26.5 percent in September 2012 while share of investments declined to 47.1 percent from 50.4 percent in September 2012.

Figure1: Quaterly Growth of Investments and Financing

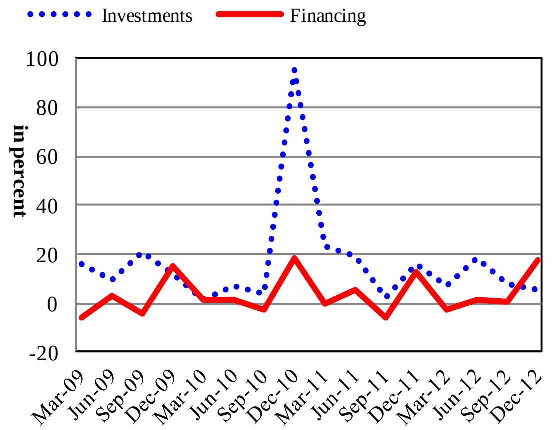

Table 3: Investments

Rupees in million

	Dec-11	Sep-12	Dec-12	Growth YoY	Growth QoQ
Federal government securities	179,049.3	265,167.9	278,549.7	55.6	5.0
Fully paid up ordinary shares	2,252.5	3,843.1	3,479.1	54.5	(9.5)
TFCs, Debentures, Bonds, & PTCs	27,539.6	32,698.8	33,899.0	23.1	3.7
Other investments	66,626.1	73,481.9	79,641.2	19.5	8.4
Investments by type					
Held for Trading	12.54	515.42	75.82	504.6	(85.3)
Available for Sale	252,326.4	351,201.1	375,665.7	48.9	7.0
Held to Maturity	13,497.8	12,769.1	9,521.4	(29.5)	(25.4)
Surplus /(deficit) on revaluation	852.8	2,335.2	1,935.5	127.0	(17.1)
Net Investments	**274,268.5**	**373,980.8**	**394,376.9**	**43.8**	**5.5**

[1] Assets of Islamic banking industry grew by 12.8 percent during Sep-Dec quarter compared to 7.1 percent growth in assets of overall banking industry during the same period.

Bifurcation of assets among full-fledged Islamic Banks (IBs) and Islamic Banking Divisions (IBDs) of conventional banks shows both IBs and IBDs witnessed positive growth in assets compared to previous quarter with IBs recording relatively better growth (13.1 percent) compared to IBDs (12.3 percent). In terms of share, assets of IBs and IBDs in overall assets of Islamic banking industry remained unchanged i.e. assets of IBs constitute 64 percent with remaining 36 percent assets are contributed by IBDs.

Investment:

Investments of Islamic banking industry grew by 5.5 percent during the quarter end and reached to Rs 394.4 billion from Rs 374.0 billion in the previous quarter (see **Table 3**). As in previous quarters, the major contribution in investments was made by investments in Federal government securities though quarterly growth rate during quarter ending December 2012 in Federal government securities was less (5.0 percent) compared to previous quarter (9.1 percent). It is important to note that despite no issuance of Sukuk during the quarter, Federal government securities still registered positive growth due to purchase of Sukuk in the secondary market by Islamic Banking institutions from conventional banks.

Table 4: Financing Mix

Rupees in billion

	Dec-11	Sep-12	Dec-12
Murabaha	92.8	81.0	96.1
Ijarah	22.1	22.0	22.4
Musharaka	5.1	2.2	1.9
Mudaraba	0.3	0.3	0.6
Diminishing Musharaka (DM)	67.9	77.8	87.5
Salam	5.1	4.7	7.3
Istisna	9.3	12.8	15.7
Qarz/Qarz-e-Hasna	0.0	0.0	0.0
Others	9.2	8.9	10.5
Total	**211.8**	**209.8**	**242.1**
% Share			
Murabaha	43.8	38.6	39.7
Ijarah	10.4	10.5	9.3
Musharaka	2.4	1.0	0.8
Mudaraba	0.1	0.2	0.2
Diminishing Musharaka (DM)	32.0	37.1	36.2
Salam	2.4	2.3	3.0
Istisna	4.4	6.1	6.5
Qarz/Qarz-e-Hasna	0.0	0.0	0.0
Others	4.4	4.3	4.3
Total	**100.0**	**100.0**	**100.0**

Financing

In line with the trend usually witnessed during the last quarter of calendar year financing to private sector by Islamic banks' registered a handsome increase of 15.4 percent. All modes of financing except Musharaka witnessed increase during the quarter under review. In terms of financing mix, Murabaha continued to have the highest share in overall financing followed by Diminishing Musharaka (see **Table 4**).

Like previous quarters, IBIs financing done is mainly concentrated in the textile sector which is line with the trend in overall banking industry. All sectors, except agribusiness registered positive growth during the quarter of CY 2012. Consequently, share of agribusiness in overall financing declined while that of other sectors including textile, electronics and electrical appliances and sugar increased during the quarter under review (see **Table 5**).

Table 5: Financing Concentration - percent share

	Dec-11	Sep-12	Dec-12	Industry
Chemical and Pharmaceuticals	7.4%	7.7%	7.4%	3.6%
Agribusiness	4.0%	5.8%	3.7%	8.4%
Textile	20.1%	15.0%	19.0%	16.7%
Cement	3.0%	1.5%	1.5%	1.4%
Sugar	3.3%	2.7%	3.8%	2.5%
Shoes and leather garments	1.6%	0.9%	0.9%	0.6%
Automobile and transportation equipment	1.4%	1.4%	1.4%	1.3%
Financial	1.2%	1.3%	1.4%	1.9%
Insurance	0.0%	0.0%	0.0%	0.0%
Electronics and electrical appliances	1.5%	1.4%	1.5%	1.4%
Production and transmission of energy	10.2%	11.9%	10.3%	11.7%
Individuals	14.9%	16.2%	14.2%	7.9%
Others	31.3%	34.1%	34.9%	42.5%
Total	100.0%	100.0%	100.0%	100.0%

Client type wise financing of IBIs remained concentrated in corporate sector with share of nearly 74 percent followed by consumer financing (13.1 percent), commodity financing (7.3 percent) and SME (4.1 percent) in overall financing (see **Table 6**).

Table 6: Client Wise Financing Portfolio (Share Percent)

	Dec-11	Sep-12	Dec-12
Corporate Sector	70.5%	70.7%	73.5%
SMEs	5.2%	4.8%	4.1%
Agriculture	0.1%	0.0%	0.1%
Consumer Finance	14.8%	14.9%	13.1%
Commodity Financing	7.4%	7.4%	7.3%
Staff Financing	1.7%	1.8%	1.7%
Others	0.3%	0.4%	0.2%
Total	100.0%	100.0%	100.0%

Asset Quality

Encouragingly the growth in non-performing financing (NPF) of Islamic banking industry reversed and the NPFs during the quarter for the first time since June 2011 registered a moderate decline and reduced to Rs.18.5 billion from Rs.18.9 billion in last quarter. The decline though modest is however indicative of some recoveries against NPFs and no or marginal increase in fresh NPFs. All categories of NPFs except the category of "Loss" witnessed decline

Table 7: Non-Performing Financing & Assets

Rupees in million

	Dec-11	Sep-12	Dec-12	Growth in % YoY	Growth in % QoQ
NPF	15,949.8	18,893.7	18,544.6	16.3	-1.8
OAEM	0.2	1.8	1.2	479.5	-35.1
Substandard	1,938.3	2,666.1	2,106.2	8.7	-21.0
Doubtful	2,967.6	2,938.8	2,451.7	-17.4	-16.6
Loss	11,043.7	13,287.1	13,985.5	26.6	5.3
Provisions	10,055.0	12,040.1	12,323.8	22.6	2.4
Net NPF	5,894.8	6,853.6	6,220.8	5.5	-9.2
Recovery (year to date)	963.0	784.0	908.6	-5.6	15.9
NPA	17,983.0	22,528.1	21,688.8	20.6	-3.7
Net NPAs	5,736.5	8,073.7	7,043.1	22.8	-12.8

during the review period as the said category reached 13.9 billion (see **Table 7**). Importantly recovery also registered higher growth (15.9 percent) during last quarter of CY 2012 compared to previous quarter (5.6 percent). Despite decrease in NPFs, provisions witnessed increase during the quarter under review mainly due to increase in NPFs in loss category. Consequently provisions to NPFs reached 66.5 percent compared to 63.7 percent in the previous quarter (see **Table 7**). Among other indicators, NPF to financing ratio, Net NPAs to Capital and Net NPFs to Net Financing, all registered decline compared to previous quarter. In particular NPF to financing ratio declined to 7.6 percent during December 2012 from 9.0 percent in September 2012 mainly due increase in financing and decrease in NPFs. It is important to mention that almost all the asset quality indicators of IBIs are significantly better than those of overall banking industry and thus are indicative of relatively better asset quality of IBIs (see **Table 8**).

Table 8: Performance Indicators

	Dec-11	Sep-12	Dec-12	Industry
Assets Quality Ratio				
NPFs to Financing	7.6%	9.0%	7.6%	14.5%
Net NPFs to Net Financing	2.9%	3.5%	2.7%	4.6%
Provisions to NPFs	63.0%	63.7%	66.5%	71.8%
Net NPAs to Total Capital	10.2%	13.2%	11.1%	20.3%
Real estate Financing to Total Financing	6.7%	6.8%	5.8%	1.4%
FCY Denominated Financing to Capital	13.0%	8.6%	7.7%	13.7%

Liabilities

Deposits of the Islamic banking industry increased from Rs. 627.8 billion by end September 2012 to Rs 706.5 billion by end December 2012 depicting a quarterly growth of 12.5 percent. This quarterly growth rate is significantly higher compared to previous quarter growth of 4.2 percent. Both customers' deposits as well as financial institutions' deposits with IBIs registered positive growth during the quarter (see **Table 9**). Thus share of Islamic banking industry deposits in overall banking industry increased to 9.7 percent in December 2012 from 9.3 percent in previous quarter.

Table 9: Break up of Deposits

Rupees in million and growth in percent

				Growth	
	Dec-11	**Sep-12**	**Dec-12**	**YoY**	**QoQ**
Deposits	**521,000.3**	**627,859.9**	**706,469.9**	**35.6**	**12.5**
Customers	**483,207.5**	**601,448.7**	**660,950.3**	**36.8**	**9.9**
Fixed Deposits	185,137.3	231,110.2	233,108.8	25.9	0.9
Saving Deposits	172,374.6	228,676.9	259,239.2	50.4	13.4
Current accounts - Remunerative	988.3	1,349.8	1,878.0	90.0	39.1
Current accounts - Non-remunerative	122,235.4	137,858.3	163,539.3	33.8	18.6
Others	2,471.9	2,453.6	3,185.0	28.8	29.8
Financial Institutions	**37,792.8**	**26,411.2**	**45,519.6**	**20.4**	**72.3**
Remunerative Deposits	37,460.3	26,087.1	35,514.6	(5.2)	36.1
Non-remunerative Deposits	332.5	324.1	10,005.0	2,908.8	2,986.7
Currency Wise					
Local Currency Deposits	499,620.5	600,989.0	672,841.5	34.7	12.0
Foreign Currency Deposits	21,379.8	26,870.9	33,628.4	57.3	25.1

Further analysis of deposits show that all types of customers' deposits registered positive growth compared to previous quarter, with fixed and saving deposits constituted major share in total deposits (see **Table 9**). Like previous quarters, local currency deposits continued to dominate overall deposits with nearly 95 percent share in overall deposits.

Earning & Profitability

The IBIs barely managed to maintain the Rs. 10 billion profit (before tax) level achieved last year due to significantly squeezed margins. The reduction of 2.5 percentage points in the policy rate translated into significant decline in yields on financing and investments[2]. While the financing and investment yields were under stress, the depositors' return remained more or less stable due to market competitiveness and regulatory directives to all banks including IBIs to pay enhanced returns to the smaller depositors (PLS). The squeezed margins translated into marginal reduction in profit before tax to Rs 10 billion from Rs 10.6 billion in CY 2011 and significant reduction in ROA and ROE to 1.2 percent and 14.1 percent from 1.6 percent and 17.3 percent respectively in CY 2011. The ROA and ROE of Islamic banking also became lower than the overall banking system averages of 1.4 percent and 14.7 percent respectively (see **Table 10**).

Table 10: Earning & Profitability	**Dec-11**	**Sep-12**	**Dec-12**	**Industry**
Net Income to Total Assets (ROA) (After Tax)	1.6%	1.2%	1.2%	1.4%
Return on Equity (ROE) (After Tax)	17.3%	14.3%	14.1%	14.7%
Net mark up Income to Gross Income	82.4%	80.3%	80.1%	71.1%
Non-mark up Income to Gross Income	17.6%	19.7%	19.9%	28.9%
Trading & Fx Gains/(Losses) to Gross Income	4.6%	7.0%	6.6%	8.7%
Operating Expense to Gross Income	60.4%	65.9%	67.3%	53.9%
Personnel Expense to Operating Expense	34.8%	34.6%	35.3%	41.6%

Box 1: World Islamic Banking Competitiveness Report 2013

Earnst & Young published the World Islamic Banking Competitiveness Report 2013 in December 2012. The report covers global industry insights (as of 2011) in addition to providing spotlight on major Islamic banking and finance countries including Bahrain, Egypt, Kuwait, Malaysia, Pakistan, Qatar, Turkey, United Arab Emirates, Indonesia and Saudi Arabia. The report also provides forecasts of the Islamic banking industry for coming years. Some of the major findings of the above mentioned report are given below:

- Islamic banking assets globally grew to US$ 1.3 trillion in 2011, suggesting an average annual growth of 19% over past four years (24% in 2011).
- Top 20 Islamic banks make up 55% of the total Islamic banking assets and are concentrated in 7 countries, including GCC, Malaysia and Turkey.
- 13 Islamic banks have an equity base of more than US$ 1 billion.

[2] As the pricing of IBs financing and investment products is based on conventional benchmarks (KIBOR and T-Bills rate), the change in SBP policy rate and resultant changes in KIBOR and T-Bill rate do impact the yields of IBIs financing and investment portfolio.

- Islamic banking growth outlook continues to be positive, growing 50% faster than overall banking sector in several core markets. High potential international markets – each in different stages of development - include Saudi Arabia, Malaysia, Qatar, Turkey and Indonesia.
- Global Islamic banking assets are forecasted to reach US$ 1.8 trillion in 2013 (US$ 1.3 trillion in 2011), and beyond the milestone of US$ 2 trillion by 2014.
- There remains considerable potential for growth with some strategic quick wins possible; retail specialization, regional diversification, transformation of middle-tier conventional banks to Islamic banks.
- Demand for sukuk instruments will continue to grow, outpacing global supply and providing opportunities for banks to establish and grow their Islamic fixed income advisory platforms.
    - Based on current growth forecast, Islamic financial institutions will require at least US$ 400b of short term, credible, liquid securities for liquidity and capital management purposes, by 2015
    - Including other investor classes, global sukuk demand could be in excess of US$ 600b by 2015
    - 2012 would see in excess of US$ 110b in new issuance – a record year but still short of industry demand
    - Market opportunity will drive more Islamic banks to set up international platforms to offer Islamic fixed income advisory services
- However, in terms of profitability, Islamic banking industry's average ROE was 12% compared to 15% for conventional in 2011. Multiple challenges relating to sub-scale operation, asset quality, negative operating income from core activities and a weak risk culture remain associated with Islamic banking industry. Hence there is need for initiating wide-ranging transformation programs around the 3 R's i.e.
    - Regulatory transformation – involving compliance risk, capital optimization, integrated balance sheet management and liquidity management
    - Risk transformation – around Shariah governance, single data management framework, segment specific risk models and fund transfer pricing capabilities
    - Retail banking transformation – strengthening customer centric operating model, channel integration and technology enablement
- A well executed transformation program would take 2-3 years to be implemented and embedded, and could improve Islamic banks' profitability by approximately 25%.

Country Model: Bangladesh

Introduction:

The People's Republic of Bangladesh is the 8th most populous country and third largest Muslim country. The history of Islamic banking in Bangladesh started with the establishment of Islamic bank Bangladesh Limited (IBBL) in 1983. Today the Islamic banking industry in the country comprises of 7 full fledged Islamic banks and 13 conventional banks having Shariah compliant windows and counters constituting more than 15 percent share of overall banking industry[3]. Six full fledge takaful operators and 13 Shariah compliant windows of conventional insurance are also operational in the country.

The highlight of Islamic Finance of Bangladesh is that it is the first country to adopt Islamic microfinance (MF) in the world. At present Islamic MF in Bangladesh though constitutes only 1 percent of MF industry of the country, however, in terms of clients it is still the largest among global Islamic MF.

Historical Evolution of Islamic banking

The initiation of Islamic banking in Bangladesh was led by a volunteer organization; the Bangladesh Islamic Bankers Association, having an objective of making Bangladesh a riba free economy. As a result of their efforts and effective lobbying the very first Islamic bank; Islami Bank Bangladesh Ltd (IBBL) was established in early 80’s. IBBL was not only the start of Islamic banking in Bangladesh but also in South East Asia. IBBL was a joint venture of multinational institutions including Islamic Development Bank (IDB) Al-Rajhi Company for Currency Exchange and Commerce of Saudi Arabia, Kuwait Finance House, Jordan Islamic Bank, Islamic Investment and Exchange Corporation of Qatar, Bahrain Islamic Bank, Islamic Banking System International Holding S.A, Dubai Islamic Bank, Kuwait Ministry of Awqaf and Islamic Affairs, with Bangladeshi government having a 5 percent share in paid up capital. Realising the lack of Shariah complaint instrument and markets in the country and to encourage new entrants the central bank of Bangladesh provided preferential provisioning like low statutory liquidity reserve (SLR) for Islamic banks compared to conventional banks .

On Regulation and Legislation front progress remained relatively slow; amendments were made to accommodate the special requirements of Islamic banks including amendments in Income Tax Ordinance (1984) that viewed the profits paid on Mudaraba as expenditure. These changes have provided a conducive environment for the growth of Islamic banking in prevailing parallel banking model; however, this remained unsuccessful in absolution of interest from the economy. The Central bank of Bangladesh, Bangladesh Bank, also established a Research and Islamic Economic Division within the bank during the start of 90’s.

[3] Source: Reuters’ report [accessed on Feb 25, 2012]

Realizing the limited avenues of investment for Islamic banks, Bangladesh Bank on behalf of the government has issued the very first Sharaih Compliant bond; "Government Islamic Investment Bond" in 2004. Subsequently in 2007, IBBL issued Mudaraba Perpetual Bond (MPB) in 2007. These bonds have provided an attractive Investment avenue for Islamic banks and have also impacted the capital market positively.

On the operational and management side, the Bangladesh Bank issued guidelines in 2009 after detailed discussion with Islamic banks as well as Central Shariah Board of the country. These guidelines cover areas like corporate and Shariah governance, product definitions and operational frameworks, alternative investment modes, and conversion of conventional banks into Islamic banks. The central bank has also issued short term money market instruments for Islamic banks enabling them to manage their liquidity efficiently.

Though the regulation and legislation for Islamic banking in the country has not been very progressive due to failure of efforts to include Islamic banking Act in the prevailing Banking Act 1991, the industry has shown considerable growth over the years.

While Islamic banking Industry has progressed in Bangladesh since the inception of the first bank in the country in 1983, in order to sustain this growth serious efforts are required to provide conducive policy environment by introducing dedicated regulatory framework for Islamic banking industry in the country. Moreover Islamic Banks need to invest in human resource and innovative products to cater to growing demands from a Muslim dominant society.

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- Z Mamun, M (2011).; "*Prospects and Problems of Islamic Banking from Bank's Perspective: A Study of Bangladesh*" 8th International Conference on Islamic Economics and Finance
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- Sarker, A.A; " *The Need for Regulatory Framework for Islamic Banks and Islamic Financial Institutions in Bangladesh*"
- Sarker,A.A; " *Islamic Banking in Bangladesh: Achievements & Challenges*"
- Reuters' report [accessed on Feb 25, 2012] http://www.reuters.com/article/2012/06/05/islamic-finance-liquidity-idUSL5E8H45DN20120605

Adoption of AAOIFI Shariah Standards: Case of Pakistan

Shariah Standard No. 3: Default in Payment by a Debtor

AAOIFI Shariah Standard No. 3; Default in Payment by a Debtor, issued in May 2000 provides explanation for Shraih rulings which are applicable to Islamic financial institutions (IFIs) in situations;

(i) delay by solvent debtor in settling their debts
(ii) delay by guarantors and contractors in fulfilling their obligations
(iii) penalty clauses

The scope of the standard expresses that this standard is not applicable to insolvent debtors or bankrupt who delays payment for any established Shariah reason.

The Shariah ruling of this standard has been categorized into six main clauses; (i) Default in payment by a debtor (ii) Guarantor (iii) Contractor or concessionaire (iv) Non-material punishment for default in payment (v) General rulings and (vi) The Establishment of default in payment

(i) Default in payment by a debtor: With regard to this category the Shariah rulings have been explained in eight sub-clauses. After mentioning the default as *Haram* by a solvent debtor in first sub clause, sub-clauses two and three express that it is not allowed to specify or to make a judicial demand for compensation in cash or any other form as a penalty clause from a debtor for delay in settling his debt. However, fourth clause discusses that the debtor will pay all expenses that creditor incurs to recover the debt and in fifth clause the creditor has been given the right to apply for the sale of the asset that has been pledged as collateral. It has also been allowed that the creditor can stipulate for debtor to give a mandate to the creditor to sell the pledged asset without any course from him (debtor) to the court. The sixth clause suggests considering an outstanding installment as default only after notifying this it to the debtor and after a reasonable period of time which should not be less than two weeks. The last two clauses are related to defaults in case of Murabaha sale ; (i) it has been advised to creditor to repossess the asset if it is available in the condition it was sold instead of initiating the bankruptcy procedure in the situation where the buyer has defaulted to settle the price and has become bankrupt (ii) To prescribe an obligation in contract in form of any amount or percentage of the payment due on debtor in case of default which would be donated to charitable cause under the bank's Shariah Supervisory board.

(ii) **Guarantor:** While focusing on the Guarantor, this clause of the standard allows the creditor to demand from guarantor to settle the debt according to Shariah principles. The clause describes that the institution is entitled to demand the settling of debt from either the debtor or guarantor provided that there is no condition in the contract asking for to seek the settlement first from debtor. Moreover all rulings applicable to debtors in default are also applicable to guarantors in default.

(iii) **Contractor or concessionaire:** The inclusion of penalty clauses in contracts for construction, supply and Istisna'a has been allowed under this clause of the standard. It has also been permitted to deduct the due amount from outstanding amount due to the contractor and in case of refusal to pay the due amount under penalty clause all rulings of default in payment by a debtor would be applicable.

(iv) **Non-material punishment for default in payment:** The institution is permitted to include the name of defaulter in black listed customers and can also exchange the same information either when inquiry is made from other companies or when exchange of black listed customers is being made between companies directly.

(v) **General rulings:** Three sub-clauses explain general rulings where the creditor institution has been allowed (i) to follow the affairs and financial dealings of a defaulting debtor (ii) accept the amount in excess to defaulted amount from debtor provided that that there is no contractual conditions (written or verbal) about the excess amount (iii) to include condition in a contract under which the institution is entitled to recoup the amount due from any of the accounts (including current and investment accounts) of the customer (in case of default)with the institution . This may be done even without the consent of the debtor only if the debt and account are of the same currency, in case of varying currency of both parties are required to agree on the exchange rate

(vi) **The Establishment of default in payment :** This clause describes when to established the default in payment; when the debtor remains unable to prove that he is insolvent to settle his debt on due date on normal demand for payment.

Adoption of AAOIFI Shariah Standard in Pakistan

As has been discussed in earlier issues of bulletin that Shariah Standards are being adopted in Pakistan in with customization after consultation with stakeholders and approval from Shariah Board at State bank of Pakistan (SBP); standard relating to ***default in payment by debtor*** has been made mandatory in the country with one amendment as follows;

Original Clause	Amendment/Clarification*
2/1/e: The creditor is entitled to apply for the sale of any asset pledged as collateral for the debt, for the liquidation of the debt. He is equally entitled to stipulate that the debtor must give a mandate to the creditor to sell the pledged asset without recourse to the courts.	The words "on giving the debtor reasonable notice of sale" shall be added after the word "debt" in 2nd line of the clause. The clause can be as;" The creditor is entitled to apply for the sale of any asset pledged as collateral for the debt *on giving the debtor reasonable notice of sale*, for the liquidation of the debt. He is equally entitled to stipulate that the debtor must give a mandate to the creditor to sell the pledged asset without recourse to the courts.

*These clarifications are added as foot note with original clauses.

Sources:

1. Shariah Standards for Islamic Financial Institutions, AAOIFI (2010)
2. Website of State Bank of Pakistan (www.sbp.org.pk)
3. Website of AAOIFI (http://www.aaoifi.com)

Events and Developments at IBD

International Training Programme "Training of Trainers"
December 17-21, 2012, NIBAF, Islamabad

SBP, in collaboration with National Institute of banking and Finance (NIBAF) and Islamic Research and Training Institute (IRTI) – a Member of the Islamic Development Bank Group (IDB), organized an international program "Training of Trainers for Islamic Banking" from 17 – 21 December 2012 at NIBAF, Islamabad. This program was in continuation of IRTI's collaboration with SBP in the area of capacity building for Islamic finance industry in Pakistan. The course was attended by both international and local speakers and participants.

Focus Group Meetings & Awareness Sessions

Director Islamic banking Department (IBD) chaired an Awareness Session on Islamic Banking conducted at **GCU, Lahore, on 4th Feb**, 2013. The same is in line with IBD's objective of improving awareness of Islamic banking among different segments of society, including academia and students. It was arranged as one of the supplementary program along with Islamic Banking Focus Group meeting at SBP-BSC Lahore office, on the same date.

In similar context along with focused group meeting at SBP-BSC in Sukkur an awareness progarmme in collaboration with IBA was conducted at **IBA campus, Sukkur,** on **February 7, 2013**

Launching of Media campaign For Promotion of Islamic Banking
February 10, 2013, SBP, Karachi

With an objective of increasing awareness about Islamic finance, a Media campaign was launched on 10th February, 2013, in a meeting of Presidents of banks. The meeting was headed by the Deputy Governor, Kazi Abdul Muktadir who emphasized on promoting the inherent strengths of Islamic finance and to remove perception issues for sustainable growth of Islamic banking industry in his welcome address. He mentioned that the campaign will be led by the industry with the support of SBP.

Islamic Banking News and Views

News

Global

SCB launches Islamic Euro Nostro Account
Standard Chartered Bank (SCB) announced the launch of the industry's first Islamic Euro Nostro Account. Islamic banks across the world will now be able to earn Shariah-compliant profits on their account balances at Standard Chartered Bank, Germany Branch, in Frankfurt.
http://www.brecorder.com/money-a-banking/198/1243881/

Indonesia's largest Islamic bank goes live with new modern core banking system
PT Bank Syariah Mandiri ('Bank Syariah Mandiri'), the largest Islamic bank in Indonesia, has

successfully installed TEMENOS T24 (T24) core banking solution to support the growth of its business. With the deployment of T24 Model Bank for Islamic banking, Bank Syariah Mandiri has been able to implement flexible core banking software, designed to mitigate operating costs and reduce operational risk.
http://rfpconnect.com/news/2012/11/7/indonesia-s-largest-islamic-bank-goes-live-with-new-modern-core-banking-system

CBO revises banking law to include Sharia operations

The board of governors of the Central Bank of Oman (CBO) has revised the legal framework of the sultanate's banking system for the implementation of Islamic banking activities in the country. According to a statement issued, the board decided to introduce amendments to the existing banking law in relation to Islamic banking.

http://www.muscatdaily.com/Archive/Business/CBO-revises-banking-law-to-include-Sharia-operations-1w8a

First Oman Islamic bank starts operations

Bank Nizwa, Oman's first dedicated Islamic bank, has opened its doors to the public to start a new era for banking in the sultanate. The launch was announced after the release of the Islamic Banking Regulatory Framework by the Central Bank of Oman. Sayyid Amjad Mohammed Ahmed Al Busaidi, chairman, Bank Nizwa, said: "The Islamic Banking Regulatory Framework, laid down by the CBO has positioned the economy of the nation towards achieving greater success."
http://www.arabianbusiness.com/first-oman-islamic-bank-starts-operations-485300.html

IBSA to extend Islamic banking in Africa

The Islamic Banking Summit Africa (IBSA) was recently launched at a ceremony in the Djibouti Palace Kempinski, Djibouti, with the aim of "capturing the Africa opportunity in Islamic finance." The event attracted over 200 leaders in the international Islamic banking and finance industry to engage in critical discussions on the subject.
http://www.observer.ug/index.php?option=com_content&view=article&id=22078:-ibsa-to-extend-islamic-banking-in-africa&catid=38:business&Itemid=68

Azerbaijan's largest bank to develop Islamic insurance and leasing

International Bank of Azerbaijan (IBA) is going to develop Islamic insurance (takaful) and Islamic leasing (ijara). "Islamic insurance does not contradict the legislation of Azerbaijan, today creation of funds to cover risks is possible. It is not against the law if an insurance company will work within any requirements.
http://www.individual.com/storyrss.php?story=166771363&hash=dec42fe4cbca916b863e2a93e51c83fc

Global demand for Sukuk to reach US$900bn by 2017 - E&Y

The global demand for Sukuk is forecasted to grow three-fold from US$300 billion to US$900 billion by 2017, according to estimates by Ernst & Young's Global **Islamic Banking** Center of Excellence.
http://inaudit.com/economy/global-demand-for-sukuk-to-reach-us900bn-by-2017-ey-25080/

National

Rising partner: A Turkey-Pakistan alliance for Islamic banking

Turkey is on track to becoming the next hub for Islamic banking and finance. Given the Ottoman legacy, the last seat of the Islamic viceregency, the government of Turkey was only required to show its commitment to Islamic finance before other players in the industry were going to join her in building a vibrant Islamic banking and finance industry.
http://tribune.com.pk/story/451643/rising-partner-a-turkey-pakistan-alliance-for-islamic-banking/

Takaful rules 2012, an opportunity for insurance under Shariah

Conventional insurance companies can open window operations of Takaful by taking benefit from Takaful rules 2012, announced by Securities and Exchange Commission of Pakistan (SECP).
The Takaful industry will progress rapidly at national level under thee rules, said Muhammad Zubair Mughal, Chief Executive Officer of AlHuda Centre of Islamic Banking and Economics, while talking to media.
http://pakobserver.net/detailnews.asp?id=168027

ADB provides grant to promote Islamic banking in Pakistan

The Asian Development Bank (ADB) has provided a $750,000 grant to promote Islamic banking in Indonesia, Pakistan, Bangladesh and Afghanistan. The money will be shared between those countries' governments to help their banking systems to meet regulatory standards set by the Islamic Financial Services Board, the ADB said.
http://dawn.com/2012/12/11/adb-provides-grant-to-promote-islamic-banking-in-pakistan/

Articles/Views

Does Islamic finance have a responsibility to reduce unemployment
http://gulfnews.com/business/banking/does-islamic-finance-have-a-responsibility-to-reduce-unemployment-1.1092049

Can Islamic finance provide salvation for the banking sector?
http://theconversation.edu.au/can-islamic-finance-provide-salvation-for-the-banking-sector-9506

Corporate Governance in IF
http://businessislamica.com/2012/03/13/corporate-governance-in-if/

Basel III and Islamic finance: friend or foe?
http://www.gulfbase.com/news/basel-iii-and-islamic-finance-friend-or-foe-/221407

Why Socially Responsible Investing And Islamic Finance Is On The Rise
http://www.forbes.com/sites/ashoka/2012/11/01/why-there-is-high-growth-potential-in-the-nexus-between-socially-responsible-investing-and-islamic-finance/

Islamic finance's growth much more than a leap of faith
http://money.aol.co.uk/2012/11/27/islamic-finances-growth-much-more-than-a-leap-of-faith/

Islamic finance industry enters 2013 with new strength
http://www.shanghaidaily.com/article/article_xinhua.asp?id=116330

Oman rules may spur reform of Islamic finance scholars
http://www.arabianbusiness.com/oman-rules-may-spur-reform-of-islamic-finance-scholars-487744.html

Annexure I

Annexure: I

Islamic Banking Branch Network

(As of December 31, 2012)

Type	Name of Bank	No of Branches*
Islamic Banks	AlBaraka Bank (Pakistan) Limited	92
	BankIslami Pakistan Limited	88
	Burj Bank Limited	67
	Dubai Islamic Bank Pakistan Limited	100
	Meezan Bank Limited	310
		657
Islamic Branches of Conventional Banks	Askari Bank Limited	33
	Bank AL Habib Limited	13
	Bank Alfalah Limited	110
	Faysal Bank Limited	52
	Habib Bank Limited	33
	Habib Metropolitan Bank Limited	4
	MCB Bank Limited	27
	National Bank of Pakistan	8
	Silkbank Limited	7
	Soneri Bank Limited	8
	Standard Chartered Bank (Pakistan) Limited	14
	The Bank of Khyber	36
	United Bank Limited	22
	Sub Total	**367**
Sub Branches	AlBaraka Bank (Pakistan) Limited	2
	Askari Bank Limited	2
	BankIslami Pakistan Limited	58
	Burj Bank Limited	8
	Habib Bank Limited	2
	United Bank Limited	1
	Sub Total	**73**
	Grand Total	**1097**

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

Annexure II

Annexure: II

Province wise Break-up of Islamic Banking Branch Network

(As of December 31, 2012)

Type	Bank Name	Azad Kashmir	Balochistan	FATA	Federal Capital	Gilgit-Baltistan	Khyber Pakhtun khwa	Punjab	Sindh	Grand Total
Islamic Banks.	AlBaraka Bank (Pakistan) Limited	1	3		4		9	46	29	92
	BankIslami Pakistan Limited	1	9	1	4	2	10	33	28	88
	Burj Bank Limited	1	2		4		3	29	28	67
	Dubai Islamic Bank Pakistan Limited	1	5		5		3	48	38	100
	Meezan Bank Limited	4	10		15		27	146	108	310
	IB. Total	**8**	**29**	**1**	**32**	**2**	**52**	**302**	**231**	**657**
Islamic Branches of Conventional Banks	Askari Bank Limited		2		2	1	6	15	7	33
	Bank AL Habib Limited		1				1	3	8	13
	Bank Alfalah Limited		4		7		6	64	29	110
	Faysal Bank Limited		2		3		13	22	12	52
	Habib Bank Limited	2	1	1	2		3	13	11	33
	Habib Metropolitan Bank Limited							1	3	4
	MCB Bank Limited		1		2		2	13	9	27
	National Bank of Pakistan	1					1	4	2	8
	Silkbank Limited				1			4	2	7
	Soneri Bank Limited		1		2	1	1	1	2	8
	Standard Chartered Bank (Pakistan) Limited				1		3	4	6	14
	The Bank of Khyber		2	2	1		24	4	3	36
	United Bank Limited	1	2		1		4	8	6	22
	SAIBBs Total	**4**	**16**	**3**	**22**	**2**	**64**	**156**	**100**	**367**
Sub Branches	AlBaraka Bank (Pakistan) Limited				1				1	2
	Askari Bank Limited				1				1	2
	BankIslami Pakistan Limited	1	6		4		3	15	29	58
	Burj Bank Limited							3	5	8
	Habib Bank Limited								2	2
	United Bank Limited						1			1
Sub Branches Total		**1**	**6**	**-**	**6**	**-**	**4**	**18**	**38**	**73**
Grand Total		**13**	**51**	**4**	**60**	**4**	**120**	**476**	**369**	**1,097**

Annexure III

Annexure: III

District wise Break-up of Islamic Banking Branch Network

(As of December 31, 2012)

S. No	Province	District	No of Branches
1	Sindh	Badin	2
2		Dadu	3
3		Ghotki	1
4		Hyderabad	23
5		Jacobabad	1
6		Karachi City	305
7		Larkana	3
8		Matiari	1
9		Mirpurkhas	4
10		Naushero Feroze	1
11		Nawabshah	5
12		Sanghar	6
13		Sukkur	10
14		Tando Allahyar	3
15		Tando Mohamma	1
Sindh Total			**369**
16	Punjab	Attock	9
17		Bahawalnagar	5
18		Bahawalpur	4
19		Chakwal	6
20		Dera Ghazi Khan	3
21		Faisalabad	46
22		Gujranwala	20
23		Gujrat	18
24		Hafizabad	2
25		Jhang	3
26		Jhelum	7
27		Kasur	3
28		Khanewal	9
29		Khushab	5
30		Lahore City	171
31		Layyah	1
32		Lodhran	1
33		Mandi Bahauddir	1
34		Mianwali	2
35		Multan	32
36		Muzaffargarh	3
37		Okara	6
38		Pakpattan	2
39		Rahim Yar Khan	12
40		Rawalpindi	56
41		Sahiwal	5
42		Sargodha	12
43		Sheikhupura	6
44		Sialkot	17
45		Toba Tek Singh	3
46		Vehari	6
Punjab Total			**476**

S. No	Province	District	No of Branches
47	Khyber Pakhtunkhwa	Abottabad	11
48		Banu	4
49		Batagram	1
50		Charsadda	4
51		Chitral	3
52		Dera Ismail Khan	5
53		Hangu	2
54		Haripur	4
55		Kohat	3
56		Lower Dir	1
57		Malakand	1
58		Mansehra	10
59		Mardan	8
60		Nowshera	4
61		Peshawar	45
62		Shangla	1
63		Swabi	4
64		Swat	5
65		Tank	1
66		Upper Dir	3
KP Total			**120**
67	Gilgit-Baltistan	Diamir	3
68		Gilgit	1
GB Total			**4**
69	**FATA**	Khyber Agency	1
70		Orakzai Agency	3
FATA Total			**4**
71	**Federal Capital**	Islamabad	60
Federal Capital Total			**60**
72	Balochistan	Chagi	1
73		Gawadar	1
74		Kila Abdullah	2
75		Killa Saifullah	3
76		Lasbela	2
77		Loralai	5
78		Pishin	1
79		Quetta	35
80		Zhob	1
Balochistan Total			**51**
81	**Azad Kashmir**	Mirpur	10
82		Muzaffarabad	3
AJK Total			**13**
Grand Total			**1097**