8 ISLAMIC BANKING

Islamic finance is based on the principles of the Islamic economic model, which defines a code of conduct according to the rulings of shariah for commercial and financial transactions. The philosophy of the model is based on the moral foundations of risk and profit-sharing, to ensure an equitable distribution of resources in the society.

As the most dominant form of Islamic finance, Islamic banking is rapidly transforming into a viable alternate form of financing. From relatively humble beginnings in 1963 when the first Islamic bank was established in Egypt, today Islamic finance boasts of assets of around US$ 1.0 trillion, and has successfully made inroads into a wide range of products such as infrastructure and housing finance, asset management, Takaful business, debt issuance via Sukuk, etc. The growth rate, particularly in recent times, has been tremendous and geographically broad-based.

Islamic banking has also made swift progress in Pakistan since its re-launch in 2002[1] as a parallel mode of financial intermediation along with conventional financial institutions, as evidenced by the commendable growth rate in excess of 60.0 percent per annum in both the assets and deposit base. Importantly, this parallel system is moving forward on the strength of its own merit, and not because of any religious or legal obligation or compulsion. As a proportion of the overall banking industry, the combined share of Islamic banks and stand-alone Islamic branches of conventional banks is 4.2 percent in deposits, and 4.3 percent in assets.[2] In comparison with other countries, these shares reflect an impressive performance in a short span of 6 years: Bahrain, Malaysia and Indonesia have respective shares of 8.0 percent achieved over 30 years, 13.0 percent over 25 years and 1.7 percent over the last decade or so. To capitalise on the pace and momentum of this growth, SBP has recently launched its Strategic Plan for the Islamic banking industry, which envisions increasing its share to 12.0 percent of the overall banking industry by 2012.[3]

This chapter gives a detailed performance review of Islamic banking in Pakistan during the year CY07 and H1-CY08.[4] After briefly highlighting international developments, it discusses the key performance indicators, and the financial soundness and stability of Islamic banks in the current macroeconomic environment, while also giving an assessment of the risks and the key developments during the year.

8.1 International Developments

Table 8.1 shows the geographical distribution and growth of assets managed by the top 500 Islamic financial institutions. Evidently, the appeal and acceptability of Islamic banking has increased tremendously in recent years, particularly in the Gulf and in predominantly Muslim countries. According to an estimate by S&P's Ratings Services, as much as 20.0 percent of banking customers would now

Table 8.1: Assets Managed by the Top 500 Islamic Institutions
billion US$

Region	2007	2006	%Change
Gulf Cooperation Council (GCC)	178.1	127.8	39.4
Non-GCC MENA*	176.8	136.1	29.9
MENA Total	354.9	263.9	34.5
Sub-Saharan Africa	4.7	3.0	54.9
Asia	119.3	98.7	20.9
Australia/Europe/US	21.5	20.3	5.8
Global	**500.5**	**386.3**	**29.6**

Source: Banker Magazine 2008
*Middle-East and North Africa

[1] For a background review, please see Chapter 4, Financial Sector Assessment 2004, State Bank of Pakistan.
[2] As of end-June CY08.
[3] Strategic Plan for Islamic Banking Industry of Pakistan (September 2008), Islamic Banking Department, State Bank of Pakistan.
[4] Data from the Islamic Banking Department (IBD) includes statistics for Islamic banking branches of conventional banks, whereas the data from the Banking Surveillance Department (BSD) is on the 6 dedicated Islamic Banks. In some instances, comparison has been made on an annual basis in which case the data shown is upto end-CY07.

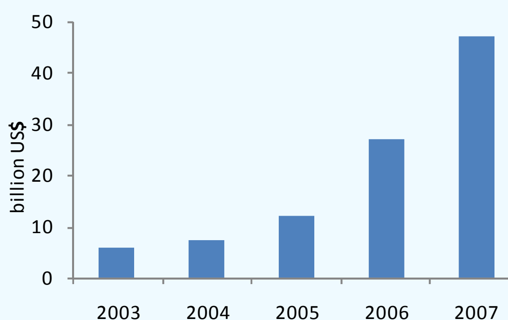
spontaneously choose an Islamic financial product over a conventional one, with a similar risk-return profile, in these regions.[5] Although Islamic finance is more dominant in Muslim countries, in recent years its presence in international financial hubs like London, Tokyo, Hong Kong and Singapore has increased significantly. A ranking of countries in terms of the asset size of Islamic finance shows that UK has shariah-compliant assets of US$ 10.4 billion, where London is now aspiring to be the emerging global hub for Islamic finance. The country's keen interest in this area is reflected by the fact that the Financial Services Authority (FSA) in UK has authorized 3 dedicated Islamic banks since 2004, initiated by Middle-Eastern investors and institutions, while other applications are in the pipeline. It has also authorized an Islamic hedge fund manager and is considering applications for a Takaful provider. More importantly, there is a level playing field in dealing with applications from conventional and Islamic firms.[6]

Box 8.1: Sukuk - The Islamic Alternate to Conventional Bonds

Global Sukuk issuance is set to exceed the US$ 100 billion mark by the end of the decade. Sukuk are now one of the dominant securities, and an attractive mode of raising finance, particularly in Malaysia and the GCC countries. The non-Muslim world is also honing in on Sukuk, with issuers aiming to tap into surplus liquidity flowing from the Gulf region, while sovereigns such as U.K. and Japan are also exploring the possibility of issuing Sukuk.

Although Sukuk issuance has been on the rise, a certain slowdown has been seen in the growth rate of the number of issuances recently: only 207 Sukuk were issued globally in 2007, compared to 199 in 2006 and 89 in 2005. Some observers attribute this slow growth in issuance to the global financial crisis. It should, however, be pointed out that although the number of issues did not increase significantly, the average issuance size did increase (**Figure 1**). The Sukuk market is expected to show resilience in the current credit turmoil because there is no appetite for margin lending and CDOs based on asset backed securitization in Islamic finance. Any slowdown, if at all, will be short run in nature, with higher demand expected to be seen in the future, as the Middle East becomes the new bastion of financial activity in the wake of the prevailing financial crisis.

Figure 1: Global Sukuk Issue



Source: IFIS & Standard and Poor's

There was considerable diversity in the structures issued during 2007, and included sukuk based on *Bai' Bithaman Ajil* (BBA), *Istisna*', *Mudharabah, Ijarah, Musharakah,* and *Wakala* contracts. Sukuk have become the primary security in the investment portfolio of Islamic banks, though these instruments are largely kept in the "Held to Maturity" category, rather than being actively traded. Malaysia remains the world's leader in Sukuk issuance by both number and value, with the 2007 trade totaling about US$ 25 billion. Another remarkable feature of 2007 was the explosion in the number of sukuk worth more than US$ 1.0 billion each. There were only 4 such sukuk in 2006 - 2 in the UAE and 2 in Malaysia - but in 2007 there were 14 such issues, spread between Malaysia with 6, the UAE with 5 and Saudi Arabia with 3. These 14 sukuk alone represented 56.0 percent of the total value of the global market.

Interestingly, in 2007 most of the Sukuk issuance was managed by western conventional investment banks rather than Islamic investment banks. While this situation might change in the near future given the recent developments in global financial markets, there are several reasons for conventional banks to have acquired a leading role in the first place. First, conventional banks are better equipped because of their expertise in financial engineering and structuring transactions. Second, they have more sophisticated and larger sales channels to market the issues. There is also a growing trend of conventional investors investing in Sukuk as they see better value in doing so. Third, conventional banks are working more aggressively to capture this growing field, especially in the GCC countries. The growing interest in Sukuk will also help strengthen their secondary markets which in turn would improve the liquidity management of Islamic banks.

Sources: Zamir Iqbal (2008), New Issues in Islamic Finance; 2. IFIS report; 3. Standard and Poor's Islamic Finance Outlook 2008.

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[5] Islamic Finance Outlook 2008, Standard and Poor's.

[6] The FSA's approach is summed up as "no obstacles, but no special favours", as discussed in "Islamic Finance in the UK: Regulation and Challenges", November 2007, Financial Services Authority (FSA), UK.

On a similar pattern, global Sukuk issuance has also seen a tremendous boom in recent years (**Box 8.1**).

The ongoing financial crisis in advanced economies has actually given a boost to the appeal of Islamic Finance, which is built on transactions backed by real assets, and stricter lending principles (**Box 8.2**).

Box 8.2 : Global Financial Crisis and Islamic Banks

Since the global financial crisis which started in 2007 primarily originated from the sub-prime mortgage portfolio which was spun off into securitized instruments subsequently offered as investments, an immediate assessment of the impact of the crisis on Islamic banks was that they were not affected because Islamic finance is based on and reinforces a close link between financial and productive flows. However, the protracted duration of the crisis has now started to impact the functioning of Islamic banks as well, not because these institutions have a direct exposure to any of these derivative instruments, but simply because Islamic financing contracts are based on asset backed transactions. With a downturn in the economy in most advanced countries, and an impending global recession, property markets have seen a decline in a number of countries where Islamic financial institutions constitute a significant presence. This carries negative implications for these institutions as a large number of Islamic finance contracts are backed by real estate and property as collateral. In such a situation, credit risk arises from erosion in the value of the collateral, especially in places like the highly leveraged emirate of Dubai, where a large chunk of financing is against the once booming real estate market.

Although Islamic banks in the Middle East and North Africa region have produced rosy results for the first nine months of 2008, the outlook for next year is expected to be more subdued, particularly for institutions heavily exposed to the real estate sector.

Notwithstanding, the region is expected to suffer less than the more advanced economies in which recession has already set in. The outlook for Islamic finance remains strong, given that in the face of the turmoil, most conventional financial institutions are also in the process of establishing Islamic windows and shariah-compliant products to protect their loan portfolio from the kinds of risks it can fall prey to.

8.2 Performance of Islamic Banking in Pakistan

As mentioned earlier, Islamic banking in Pakistan has grown rapidly in the last few years. Keeping in view the small size of the industry and its evolutionary nature, the growth achieved so far has been impressive and has persistently outpaced its conventional counterparts.

The consistently high average growth rate is attributed to the entry of four new players in the market in CY06 and CY07. At present there are six Islamic banks (IBs) operating in Pakistan with a branch network of 228. Additionally, SBP has also allowed conventional banks to open stand-alone Islamic bank branches (IBBs), and there are 103 such branches of 12 conventional banks (**Table 8.2**), taking the total number of branches to 331 by end August, CY08.[7]

Table 8.2 : Growth of Islamic Banking

	Amount (Rs. Billion)				Growth (percent)		
	CY05	CY06	CY07	H1-CY08	CY05	CY06	CY07
Total Assets	71.5	119.9	205.9	235.3	62.0	66.9	71.6
Deposits	49.9	83.7	147.3	168.9	65.0	67.7	76.0
Financing and Investments	47.6	72.9	137.8	166.4	61.0	53.1	89.0
No. of branches	70	150	289	331			

Note: These figures are inclusive of stand-alone branches of conventional banks. Number of branches is as of end-Aug CY08.
Source: Islamic Banking Department, State Bank of Pakistan

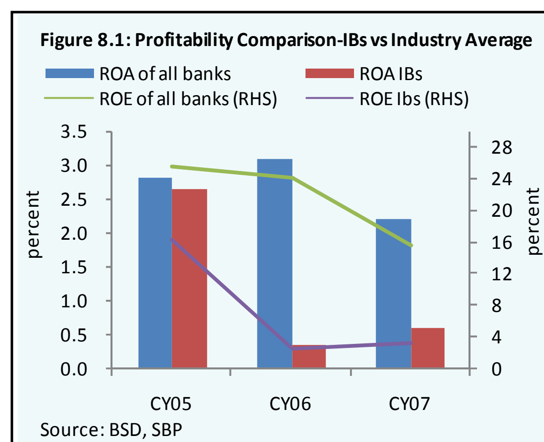
Though the performance in terms of growth of assets is impressive, it has not translated into a proportionate increase in profitability as reflected in the ROA and ROE for Islamic banks. At 0.6 and 3.3 percent for CY07 respectively,[8] these ratios for Islamic banks are below the overall banking sector average. Notably however, these indicators do not portray the actual picture due to the entry of four new banks in the market which started operations as recently as CY06 and

[7] Islamic Banking Bulletin, Jan-March 2008, Islamic Banking Department, State Bank of Pakistan.
[8] This figure pertains to the 6 Islamic banks.

CY07, and are still in the process of establishing their business, expanding their deposit base and enhancing the scope of their operations. It would normally take a new bank 3-4 years to become profitable and start operating efficiently, i.e. once the start-up costs and the expenditure on the development of management systems and related infrastructure, start to yield results. This is evident from **Figure 8.1**, which shows a higher ROA (2.6 percent) and ROE (16.3 percent) in CY05, when there were only 2 dedicated Islamic banks operating in the industry. Both indicators declined sharply in the subsequent year (with a marginal improvement in CY07) simply due to the enhanced capital and asset base effect: the new banks contributed a significant amount to the total capital and asset base of the Islamic banking industry, but the earnings are still largely concentrated in the two previously established banks in the sector. Both ROA and ROE for the industry are expected to increase in coming years, as the new banks establish themselves on a sound footing. That said, the current strains on the macroeconomic environment might exacerbate this process.

The entry of four new players bodes well for instilling competition and efficiency in the industry. Prior to this expansion in the sector, the industry was growing in a rather complacent manner and one of the leading Islamic banks enjoyed a monopoly power of sorts. However the new entrants have compelled the old established players to offer more competitive products and services, and extend their outreach to capture a bigger share of the market.

Figure 8.1: Profitability Comparison-IBs vs Industry Average



Source: BSD, SBP

As the new banks work towards creating a niche for themselves, Islamic banks as a group continue to face some challenges in running their operations, as reflected in their financial position which is discussed below. The analysis in this section is based on a comparative review of financial indicators of Islamic banks viz-a-viz the banking industry.

8.2.1 Financial Soundness and Stability of Islamic Banks

The financial soundness of Islamic banks is discussed in this section on the basis of various indicators, keeping in view the impact of the entry of the four new banks into the industry.

Asset and Liability Structure

The composition of a bank's balance sheet is one of the key determinants of the nature of risks it faces in its operating environment. **Table 8.3** gives a comparative position of the balance sheet components of the conventional banking industry and Islamic banks for CY07. On the face of it, the two columns reflect an almost similar distribution of assets and liabilities, however there are some embedded issues which make the composition of the asset-liability structure of Islamic banks relatively more peculiar, as discussed below.

The most significant issue faced by Islamic banks is that of liquidity management. The composition of their asset base reveals a dearth of shariah-compliant investment options, as evidenced by the relatively small size of the investment portfolio in comparison with conventional banks. As the weakening macroeconomic environment manifested itself in the form of a more moderate economic growth rate and credit demand in the economy in CY07, conventional banks showed an inclination for expanding their investment portfolio, which increased by 53.0 percent during the year, compared with a growth of only 10.8 percent in loans

and advances. This resulted in increasing their share of investments to 24.7 percent of total assets. While Islamic banks' investments portfolio has also increased substantially in CY07, it constitutes only 15.0 percent of the asset portfolio. Moreover, a large chunk of such investments consists of private sector Sukuk which have a relatively illiquid secondary market, and are generally held to maturity. Most of these instruments are not SLR eligible, and Islamic banks are generally required to maintain relatively larger cash balances in order to meet the 9.0 percent SLR requirement,[9] which carries a high opportunity cost in an environment of rising interest rates. This situation is deemed to improve to some extent given the recent launch of the Government of Pakistan Ijara Sukuk (**Box 8.3**). However what is still direly needed is a product or mechanism (such as repos / reverse repos) which can be used in the inter-bank market.

Table 8.3: Structure of Islamic Banks vs the Industry

share in percent

	All Banks	Islamic Banks
	CY07	**CY07**
Assets		
Cash & Balances With Treasury Banks	9.1	9.9
Balances With Other Banks	2.9	9.0
Lending To Financial Institutions	3.7	5.8
Investments – Net	24.7	15.0
Advances – Net	52	51.9
Other Assets	7.7	8.4
Liabilities		
Bills payable	1.6	1.3
Due to financial institutions	8.7	7.3
Deposits and other accounts	74.5	71.6
Other liabilities	4.6	5.5
Equity	10.5	14.3
Total	100	100

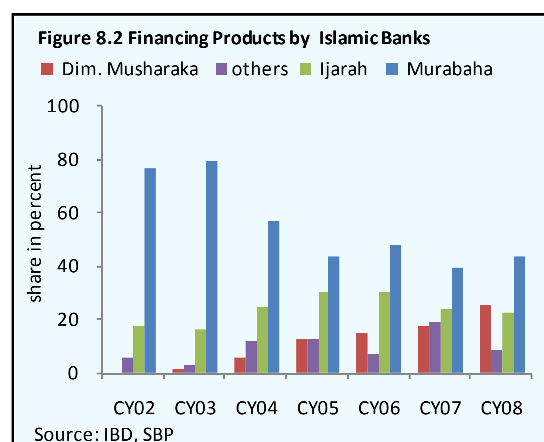
Source: BSD, SBP

While the proportion of loans and advances in both conventional and Islamic banks is around 50.0 percent of total assets, Islamic banks have a limited set of options in credit products both in terms of variety and maturity. Most importantly, Islamic banks lack an alternate to the running finance product offered by conventional banks, which seriously hampers their competitiveness in tapping a larger share of the market for working capital loans. Consequently, IBs carry a limited appeal for commercial clients who generally require a wide array of facilities from their relationship bank.

Encouragingly however, despite the lack of standardization in shariah principles, a large number of recent loan structures have used syndicated financing and privately placed sukuk to meet their client's financing requirements.

In terms of the modes of financing, **Figure 8.2** shows that Murabaha is still the mainstay of Islamic banking though its share has reduced substantially over the years. Ijarah, and in particular, Diminishing musharakah now have sizable shares. With a share of 25.4 percent, Diminishing Musharakah is currently the second most utilized mode of finance.

Figure 8.2 Financing Products by Islamic Banks



Source: IBD, SBP

[9] In order to address temporary liquidity constrains in the banking industry, SBP has exempted Time Liabilities (with tenors of 1 year and above) from SLR requirements, as notified vide BSD circular No.26, dated October 17, 2008.

Box 8.3: Corporate Sukuk Market in Pakistan and the GoP Ijara Sukuk

Sukuk have become an important component of Islamic Banks' balance sheets in Pakistan. Although the investment portfolio of Islamic banks is still smaller than that of the conventional banking industry, it has grown substantially in recent years owing to the surge in sukuk issues. Interestingly, the bulk of sukuk in the recent past have been issued by private sector companies. Although still in its initial phase, this trend is expected to strengthen the corporate bond market in general and Islamic finance in particular. According to an IFIS report, Pakistan was the fastest growing market in sukuk issues in CY07, with a substantial rise in volumes: the number of sukuk issued rose to 20 from 4 in CY06. This surge in turn has led to an increase in the size of the investment portfolio of Islamic banks from merely 6.1 percent in CY06 to around 15.0 percent of total assets in CY07.

However, one of the key problems in recent times has been the issue of managing the shortfall in SLR. The first SLR eligible sukuk certificate was launched by WAPDA in January CY06. The initial offered amount was Rs. 8.0 billion with a tenor of 6.5 years, with semi-annual coupons, and the reference rate as KIBOR. In July CY07, the second WAPDA issue was launched with an amount of Rs 8.0 billion with a tenor of 10 years. During FY07 Karachi Shipyard also issued its Rs 4.0 billion sukuk with an 8 year tenor. However, even these were eligible only up to 7.0 percent of SLR, whereas SLR for Islamic banks is 9.0 percent. For the remaining 2.0 percent, Islamic banks had to provide cash against their Time and Demand Liabilities (TDL), in addition to the CRR of 9.0 percent of TDL.

With the recent launch of the Government Ijara Sukuk, this problem is expected to be rectified to some extent. All Islamic banks and commercial banks with Islamic branches have been designated as primary dealers for the purpose of participating in the auction for the instrument. Islamic branches are not allowed to place bids separately in the auction. The Sukuk has been issued at face value and sold via competitive auctions held by the SBP, in which participation is restricted to the primary dealers. The maturity period of the first issue is 3 years from the date of issue. The profit on the Sukuk is to be paid semi-annually on the basis of the rental rate announced by the SBP prior to the start of each half year. The semi-annual profit will be benchmarked against the latest weighted average yield of the 6 month Market Treasury Bills determined one day prior to the start of each 6 month Rental Period, commencing from the issue date of the Sukuk), and re-determined in the same manner at the start of each half year. In the first auction held in September 2008, Rs. 6.5 billion worth of sukuk instruments were subscribed by both Islamic and conventional banks (**Table 1**).

Table1: Ijara Sukuk: Bank-wise share percent

Meezan Bank	38.8
Bank Al Falah	23.0
Royal Bank of Scotland	15.3
Habib Metropolitan Bank	4.6
United Bank Ltd	4.6
Bank Islami Pakistan	3.8
Dawood Islamic Bank	3.1
Standard Chartered Bank	2.0
Bank Al Habib	1.5
Soneri Bank	0.9
Albaraka Islamic Bank	0.8
Bank of Khyber	0.8
National Bank of Pakistan	0.8
Total	**100**

As reflected in the distribution of assets on the basis of modes of financing, Islamic banking in Pakistan, as in some other countries, has made little progress in venturing into equity based products, which are not only closer to the spirit of Islamic finance, but can also potentially yield higher returns. Higher potential risks and the lack of a conducive environment are the main reasons for the rather low penetration in such products (**Box 8.4**).

A comparison of the sectoral break-up of credit extended by both conventional banks and Islamic banks (**Table 8.4**) shows that consumer finance, with a share of more than 25.0 percent in the total credit base of Islamic banks, is almost totally concentrated in auto and housing finance. This is because Islamic banking is based on asset-backed transactions, and as such credit cards and personal loans are considered to be clean or unsecured loans. Incidentally, the lack of exposure to unsecured products has actually insulated Islamic banks from the adverse impact of the weakening macroeconomic environment, in which the borrower's ability to service their loans can be potentially impaired.

Box 8.4: Risks of Equity-based Modes of Financing

Equity based modes of financing entail multiple and higher risks than debt-based modes. For instance, in a Mudarabah contract, the Islamic bank is exposed to a principal-agent problem, and also faces enhanced credit risk on the amount invested with the mudarib. Equity investments can potentially lead to volatility in a financial institution's earnings due to the liquidity, credit and market risks associated with such holdings. Equity investment also entails considerable financial risk of losing the invested capital due to potential business losses. In case of equity based project finance, the nature of the contract is such that a bank does not have appropriate rights to monitor the project which is further compounded by the lack of expertise in project monitoring. Consequently, this makes the assessment as well as the management of credit risk difficult. This may often prove difficult in situations where claims of losses are made by the mudarib. In fact the agency problem is one of the major factors for the reluctance on the part of banks to undertake equity based modes of financing, as it gives entrepreneurs the incentive to under-state profits.

Lack of adequate and appropriate property rights in developing countries where Islamic finance has grown substantially, is another reason due to which the profit and loss modes of financing are riskier. Another factor that has to be borne in mind is that equity investments, other than stock market investments, do not have liquid secondary markets, which increases the cost of exit significantly.

Even 30 years after the introduction of modern Islamic banking, equity based financing still constitutes a negligible portion of the balance sheet of Islamic banks. According to an estimate, its share ranges from 0 to 24.0 percent of the balance sheet footing across the globe, with the median share at around 3.0 percent. The low share of equity based financing hampers the growth of Islamic finance, limits product and risk diversification while also limiting the real benefits which Islamic banks can potentially offer to the economy as well as to the society. The risks imbedded in these financial contracts and the lack of innovative but standardized risk mitigation measures is the leading cause as to why these modes carry limited appeal.

The lack of adequate equity based financing has led to the relatively shorter term asset maturity of Islamic banking assets. Further mismatches of assets and liabilities also arise from the heavy reliance on short-term trade financing and low penetration of equity financing arrangements like Mudarabah and Musharakah. The outcome is the dominance of short-term, low-profit and fixed income-like assets, i.e. mark-up based trade financing which limits the funds that can be invested in longer-term, more profitable but riskier assets.

Table 8.4: Sector -Wise Comparison of Islamic Banks and Conventional Banks for CY07
Amount in million Rupees, share in percent

	Banking Industry		Islamic Banks		Share of Islamic Banks	
Sector	No. of Borrowers	Amount	No. of Borrowers	Amount	No. of Borrowers	Amount
Corporate	26,061	1,520,130	1,959	62,784	7.5	4.1
SMEs	185,039	437,351	2,685	12,535	1.5	2.9
Agriculture	1,415,353	150,777	159	13	0.0	0.0
Consumer finance	3,025,463	371,421	36,533	28,843	1.2	7.8
Commodity finance	2,616	148,447	31	1,118	1.2	0.8
Others	126,021	72,758	1,148	2,459	0.9	3.4
Total	4,780,553	2,700,883	42,515	107,752	0.9	4.0

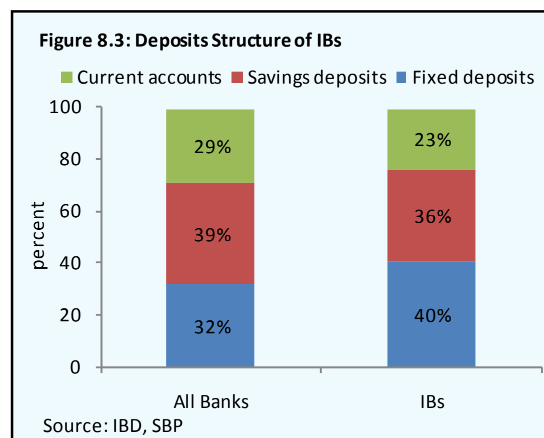
Source: Islamic Banking Department, State Bank of Pakistan

Evidently, Islamic banks can potentially increase their penetration in SME, agriculture finance and commodity financing. Also, even though these banks had a share of 4.0 percent in total bank credit in CY07, their share in the number of borrowers of the banking sector was just 0.9 percent at end-CY07. This is mainly because around 93.0 percent customers of the conventional banking industry, as shown in **Table 8.4**, are concentrated in the consumer finance and agriculture finance sectors. The low geographical outreach constrains the ability of Islamic banks to venture into the SME and agriculture sectors. It is imperative that Islamic banks make strenuous efforts to extend their outreach in order to increase the penetration of their products and services across the

country. Extending outreach is also one of the five pillars of the Islamic banking vision and strategy set out by the SBP.

On the liability side, the deposit structure of Islamic banks is somewhat skewed towards fixed deposits which pay higher returns (**Figure 8.3**). Again due to the limited outreach, Islamic banks find it difficult to tap lower cost transactional accounts (current and savings accounts), resulting in a higher cost of deposits.

Figure 8.3: Deposits Structure of IBs



Source: IBD, SBP

Earnings and Profitability

Table 8.5 shows the key cost and earnings ratios of Islamic banks which explain the impact of the asset-liability structure of these banks on their profitability. Due to the high-cost nature of the deposits, the average spread earned by Islamic banks is 2.4 percent: much lower than the industry average. Also, as mentioned earlier, the high start-up costs of the new players in the market have resulted in a higher proportion of overhead expenses for these banks, as reflected in their administrative cost to gross income ratio which is around 75.0 percent, compared to the industry average of 42.1 percent.

Table 8.5: Cost and Income Ratios CY07
percent

Ratios	All Banks	Islamic Banks
Interest Income/Mark-up to Total Assets	8.1	5.6
Net Interest Income/Mark-up to Total Assets	4.2	2.8
Non-Interest/Mark-up Income to Total Assets	1.9	1.5
NIM/NMM* (based on earning assets)	5.0	3.4
Average Cost Of Deposits & Borrowings	4.6	4.9
Avg. Return On Advances & Investments	9.6	7.3
Average Spread	5.1	2.4
Earnings(pre- provision and tax) to Net Loans/Financing	6.2	2.1
Operating Cost to Deposits	3.3	5.2
Return on Loans & Advances	10.4	10.4
Cost of Deposits	4.3	6.5
Spread	6.1	3.9
Admin Expense to Gross Income	42.1	74.9
Return on Total Advances	9.8	10.3
Effective Return on Gross Loans	7.6	9.2
Return on Performing Loans	10.5	10.4

*NMM – Net Mark-up Margin
Source: Banking Surveillance Department

Interestingly, Islamic banks earn almost the same return (and in some cases higher) on advances as conventional banks, but the earnings are substantially lower when both investments and advances are taken into account. Against the industry average of 9.6 percent, the average return on advances and investments for Islamic banks is 7.3 percent. Lower earnings on assets have resulted in a lower mark-up income to total assets ratio. Evidently, Islamic banks have not been able to compensate for the lower returns earned from advances and investments with a higher fee-based income: the non mark-up income to total assets ratio is at 1.5 percent, lower than the industry average of 1.9 percent. This is a crucial area where the domestic Islamic banks have yet to make any substantial progress. Technically, an Islamic bank can potentially earn relatively higher non mark-up income, as its structure is akin to that of universal banking but in Pakistan this is not the case as Islamic banks have not diversified well into equity based financing and investment banking etc.

It is clear that Islamic banks need to increase their outreach to be able to raise low cost deposits and achieve economies of scale. On the asset side, they need product diversification for better returns and to establish their niche. Islamic banks would be hard pressed to compete with

conventional banks on quasi-debt products and therefore venture capital and equity based products could potentially provide them the opportunity to expand their business.

Capital Adequacy

A strong capital base helps to absorb unexpected losses and thus protect the stakeholders' interest. In recognition of its importance, supervisory authorities have, across the globe, instituted minimum capital adequacy ratios for the financial institutions in their respective jurisdictions. The regulatory capital adequacy ratio (CAR) then becomes the primary determinant of the lending capacity of a bank.

Table 8.6: Capital Adequacy of Islamic Banks as of H1-CY08
percent

	Capital Adequacy Ratio	
	Basel I	**Basel II**
Meezan Bank	11.0	10.7
Dubai Islamic Bank	18.8	18.6
Bank Islami	33.0	35.4
Dawood Islamic Bank	48.1	48.3
Emirate Global Islamic Bank	40.2	35.0
Albaraka Islamic Bank	14.6	12.5

Source: Banking Surveillance Department

As shown in **Table 8.6**, the CAR of the six dedicated Islamic banks is not only well above the existing requirement of 8.0 percent, but also already meets the new requirement of 9.0 percent which comes into effect from December 31, 2008.[10] It is pertinent to mention that the relatively lower CAR under the Basel II framework is mainly due to higher deductions from the eligible capital in comparison with deductions under Basel I, and inclusion of the amount for Operational Risk, which is not included in the total risk- weighted amount under the Basel I framework. The substantially higher ratio for some banks indicates their reliance on capital for expanding their business.

All Islamic banks also meet the existing MCR requirements of Rs. 4.0 billion, except Al Baraka Islamic Bank, which is allowed to operate with a paid-up capital base of Rs. 2.0 billion in its capacity as a branch of a foreign bank.[11]

An assessment of Financial Soundness Indicators (FSIs) of Islamic banks (**Table 8.7**) shows that these institutions as a group are more financially sound in comparison with the industry as a whole. The higher capital base ensures that these banks are well equipped to meet various kinds of shocks, if and when they arise. Most importantly, their core capital to risk weighted assets ratio is substantially higher than conventional banks, making them more resilient.

Table 8.7: Financial soundness Indicators
percent

	Banking Industry			Islamic Banks		
	CY05	**CY06**	**CY07**	**CY05**	**CY06**	**CY07**
Total Capital to Total RWA	11.3	12.7	13.2	14.0	20.8	21.2
Core Capital (Tier 1 Capital) to Total RWA	8.3	16.6	10.5	13.8	20.7	20.8
Total Capital to Total Assets	7.9	9.4	10.5	11.8	16.1	16.9
Equity to Total Liabilities	8.7	10.2	11.8	19.5	25.7	24.5
Net Non-Performing Advances To Capital (including surplus)	14.3	9.7	5.6	2.9	1.9	-0.5
Net Non-Performing Advances To Core Capital	18.9	11.5	6.8	2.9	1.9	-0.5

Source: Banking Surveillance Department

8.3 Assessment of Risks

Risks in Islamic banking emanate from its inherently unique structure which is based on prohibition of interest, risk-sharing and asset-based transactions. While Islamic banks face risks

[10] BSD Circular No. 30 dated November 25, 2008.

[11] BSD Circular No.6 dated October 28, 2005 specifies that a branch of a foreign bank whose head-offices hold a minimum paid up capital of US$ 100 million (net of losses) and have a CAR of 9.0 percent can be allowed to continue to maintain the minimum assigned capital of Rs. 2.0 billion.

similar to those faced by conventional banks, other more specific risks applicable for Islamic banks necessitate a different approach to overall risk management for IBs. Keeping in line with IFSB standards, SBP has issued the Risk Management guidelines for Islamic Banking institutions[12] which identify and suggest techniques to manage the various types of risks unique to these institutions. The principles of risks management contained in these guidelines are designed to complement the current risk management principles issued by the Basel Committee on Banking Supervision (BCBS) and other international standard-setting bodies.

Credit Risk

Given the current distribution of Islamic banking assets in terms of the modes of financing, the *Murabahah* structure together with *Ijara* and *Diminishing Musharika*, dominates the balance sheets of Islamic banks. Consequently, due to their similarity with conventional products, credit risk, which is the risk of default of the counterparty or the deterioration in the repayment capacity of the borrower, is the most important risk that Islamic banks need to keep a close check on.

Table 8.8 : Sector wise break up of Financing (Before Provision)

Amount in million Rupees, share in percent

	CY05		CY06		CY07		CY08*	
Total Financing	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**
Corporate Sector	25,930	56.2	40,373	61.4	62,784	58.3	81,165	60.9
SMEs	6,771	14.7	8,542	13.0	12,535	11.6	15,452	11.6
Agriculture	88	0.2	2	0.0	13	0.0	171	0.1
Consumer Finance	10,012	21.7	15,022	22.8	28,843	26.8	31,729	23.8
Commodity Finance	3,116	6.7	625	1.0	1,118	1.0	1,855	1.4
Others	255	0.5	1,178	1.8	2,458	2.3	2,836	2.1
Total	46,173	100.0	65,742	100.0	107,752	100.0	133,208	100.0

*CY08 data upto end-June

Source: Islamic Banking Department, State Bank of Pakistan

During CY07, the credit portfolio of Islamic banks has increased by a substantial 63.0 percent (**Table 8.8**), mainly on account of growth in financing for both the corporate and consumer sectors. At end-CY07, the corporate sector accounted for 58.3 percent, whereas consumer finance constituted 26.8 percent of the total credit portfolio.

As is the case with the banking sector, Islamic banks are also faced with concentration risk due to the high exposure towards the corporate sector. Moreover, in Islamic banks, the ratio of number of borrowers to the amount of loan is lower than in conventional banks, which indicates that the risk is spread over a smaller number of borrowers. Even in consumer finance which has a high share in the credit exposure of Islamic banks, the number of borrowers is relatively small.

Table 8.9: Sectoral Distribution of Loans to Private Sector (CY07)

	Industry	IBs
Manufacturing	**41.8**	**45.5**
O/w Textile	*18.5*	*21.8*
Construction	2.5	4.6
Electricity, gas and water supply	2.6	1.6
Real estate, renting and related activities	4.3	2.5
Commerce and Trade	8.5	11.2
Private Sector Enterprises	**72.1**	**73.8**

Source: Statistics Department

Within credit to the private sector, a detailed break-up of data reveals an almost identical diversification pattern in Islamic banks as in the industry (**Table 8.9**). Similar to conventional banks, credit extended to the textile sector by Islamic banks is almost 22.0 percent of total credit, indicating sectoral concentration risk. This is of particular concern given the infection ratio of

[12] IBD Circular No.1, dated January 2, 2008.

loans to the textile sector at 12.6 percent at end-H1 CY08 (10.7 percent at end-CY07), compared to 7.7 percent for the overall loan portfolio.[13] Similarly, large-sized loans (loans of amounts over Rs 10.0 million) constitute 66.0 percent of the loan portfolio. **Table 8.10** further shows that concentration in these loans is increasing with time.

However, the quality of the credit portfolio is actually better than conventional banks as reflected by the data on NPLs. **Table 8.11** shows that not only do Islamic banks have substantially lower NPLs, but are also well-insulated through adequate provisions and capital cushion. Moreover, a stress-testing exercise based on CY08 data shows that Islamic banks are generally resilient towards shocks of a moderate level to credit risk factors **(Table 8.12).**

Table 8.10: Distribution of Loans by Size
percent share

Loan Size (million Rupees)	CY07	H1-CY08
Up to 0.1	0.1	0.04
0.1 to 0.5	3.9	4.6
0.5 to 1.0	9.9	7.8
1.0 to 5.0	13.5	12.6
5.0 to 10.0	9.2	8.7
Over 10.0	63.4	66.3

Source: Statistics Department

Table 8.11: Asset Quality Comparison
percent

	Banking Industry			Islamic Banks		
	CY05	CY06	CY07	CY05	CY06	CY07
NPLs to Advances	8.3	6.9	7.2	1.7	1.6	1.3
Net NPLs to Net Advances	2.1	1.6	1.3	0.6	0.6	-0.2
Net NPLs to Total Assets	1.1	0.9	0.6	0.3	0.3	-0.1
Provisions to NPLs	76.8	77.9	85.1	66.6	64.4	113.1
Net NPLs to Total Capital	14.1	9.7	5.6	2.9	1.9	-0.5

Source: Banking Surveillance Department

Table 8.12 : Assumed Shocks to Risk Factors

Credit Risk

C-1: A 12 percent increase in NPLs (100% provisioning against increased NPLs).

C-2: A shift in categories of classified loans (all loans classified as OAEM become substandard, all substandard loans become doubtful, and all doubtful loans become loss)

C-3: Both C-1 and C-2 occur simultaneously

C-4: A 10 percentage points increase in the NPLs to Loans ratio of consumer finance (100% provisioning against increased NPLs)

Market Risk: Interest Rate Risk

IR-1: An increase in interest rates by 200 basis points.

IR-2: A shift and steepening in the yield curve by increasing interest rates of all the three maturities (by 50, 100, and 150 basis points)

IR-3: A shift coupled with flattening of the yield curve by increasing 150,120 and 100 basis points in the three maturities respectively.

Market Risk: Exchange Rate Risk

ER-1: A depreciation of ER by 13 percent (closer to the highest change in the monthly average PKR/US$ exchange rate (12.8) over the period from Jan 1994, in September 2000).

ER-2: Hypothetical assumption of appreciation of rupee by 10 percent.

Market Risk: Equity Price Risk

E-1: A 30 percent fall in the equity prices.

E-2: A 50 percent decline in the equity prices

Liquidity Risk

L-1: A 5 percent decline in liquid liabilities and its impact on the liquidity coverage ratio calculated after excluding Govt. securities under the Held to Maturity category from liquid assets.

L-2: A 10 percent decline in liquid liabilities and its impact on the liquidity coverage ratio calculated after excluding Govt. securities under the Held to Maturity category from liquid assets.

The strong capital base has provided adequate cushion to these banks against adverse movements in the risk factors.

[13] These numbers pertain to the entire banking industry.

The results of shocks to credit risk factors (**Table 8.13**) show that the impact of an increase in NPLs by 12.0 percent (equivalent to doubling the actual increase during the June-08 quarter), directly downgraded to the loss category (requiring 100 percent provisioning), can be easily absorbed by these banks, as the post-shock CAR for all banks ranges between 9.6 percent to 48.2 percent.

Table 8.13: Impact of Sensitivity Analysis
percent

		Dec-07	Jun-08
		CAR-After Shock	CAR-After Shock
Credit Shocks			
C-1	Deterioration in the quality of loan	(10.6-51.9)	(10.4-48.2)
C-2	Shift in categories of classified loans	(10.6-51.9)	(10.1-48.2)
C-3	Cumulative impact of all shocks in 1 and 2	(10.5-51.9)	(9.8-48.2)
C-4	Deterioration in NPLs ratio of consumer finance	(9.7-51.8)	(9.6-48.1)
Market Shocks - Interest Rate Shocks			
IR-1	Shift in the yield curve	(9.9-50.9)	(9.7-46.8)
IR-2	Shift and steepening of the yield curve	(10.1-51.2)	(9.9-47.2)
IR-3	Shift & flattening of the yield curve	(10.3-51.4)	(10.2-47.5)
Market Shocks - Exchange Rate Shocks			
ER-1	Depreciation of Rs/US$ exchange rate (the historical high)	(10.8-51.9)	(10.6-48.7)
ER-2	Appreciation of Rs/US$ exchange rate (hypothetical)	(10.7-51.9)	(10.8-47.9)
Market Shocks - Equity Price Shocks			
E-1	Fall in the KSE index (historical high)	(10.5-51.9)	(10.2-48.2)
E-2	Fall in the KSE index (hypothetical scenario)	(10.3-51.9)	(9.9-48.2)
Liquidity Shocks			
Liquidity Coverage Ratio		Stressed	Stressed
L-1	5 Percent Fall in Liquid Liabilities	(21.9-41.9)	(14.1-43.6)
L-2	10 Percent Fall in Liquid Liabilities	(17.6-38.6)	(9.3-40.5)

* Based on Basel II framework

Note: The results have not been adjusted for deferred tax benefits accrued on these losses.

These banks are also resilient towards a 100.0 percent adverse shift in NPLs categories i.e. all substandard loans downgraded to doubtful and all doubtful loans shifted into loss. The combined impact of the above two shocks, in addition to the shock of an increase in infection ratio of consumer loans by 10.0 percentage points, is also comfortably absorbed by these banks.
In sum, Islamic banks have are well placed in credit risk management. Their substantial capital base, along with lower than industry proportion of non-performing loans, indicates a resilient operating base. Going forward, concentration risk would need to be monitored closely given the rapidly changing dynamics of the macroeconomic environment.

Liquidity Risk

In comparison with their conventional counterparts, Islamic banks have a lower liquid assets to total assets ratio, primarily due to lower SLR requirements given the lack of shariah-compliant liquidity management instruments. On the other hand, these banks demonstrate higher advances to deposit Ratio (ADR), which indicates their reliance on capital to finance assets, given their relatively smaller deposit base (**Table 8.14**).

Interestingly, issues of liquidity management underpin the maturity gap profile of Islamic banks. The gap is mostly negative in the first two maturities i.e. up to 3 months, and 3 months to one year. Comparatively, it is the latter maturity bucket that shows the largest negative gap, indicating that majority of the liabilities of IBs are in this tenor, while assets are generally of a

longer duration. The negative gap in this bucket is relatively higher than that of conventional banks. The longer term buckets have substantially positive gaps for all Islamic banks. On closer scrutiny, the following features of the asset-liability structure of Islamic Banks stand out, which could potentially have resulted in the existing maturity-gap profile: i) as most of the Islamic banks are still new and have a limited branch network, they have yet to accumulate sizeable amounts of current deposits, and they mostly rely on fixed deposits of tenors ranging from 3 months to 1 year; ii) their key SLR eligible instruments are not MTBs but Sukuk. Unlike MTBs, which have maturities of 3, 6 and 12 months, Sukuk are generally of longer tenors with maturities of 3 to 5 years. Technically, all the outstanding Sukuk issues fall in the longer term maturity bucket, yet they are actually counted as liquid.

Table 8.14: Liquidity Ratios
percent

	Banking Industry			Islamic Banks		
	CY05	**CY06**	**CY07**	**CY05**	**CY06**	**CY07**
Loan and Advances to Total Deposits	70.2	74.6	69.8	119.3	101.0	78.1
Loans to Deposits Ratio: Net of Export Refinance Borrowings	66.5	70.3	67.1	100.1	85.7	73.9
Growth rate of Deposits	18.3	14.9	18.4	51.1	64.4	93.2
Liquid assets to Total Assets	33.7	31.9	33.6	30.4	28.2	20.5
Liquid assets to Deposits	43.5	42.7	45.1	41.8	40.4	20.5

Source: Banking Surveillance Department

The newly launched Government Ijara Sukuk is expected to improve the liquidity management of the Islamic banks as it is an SLR eligible instrument. However, Islamic banks still need to develop an inter-bank product to ensure more efficient liquidity management. Results of the sensitivity analysis for liquidity shocks show that the liquidity coverage ratio of Islamic banks can absorb shocks of moderate intensity.

Market Risk

Market risk can arise from an adverse movement in interest rates, decline in equity prices and/or adverse movement in the exchange rate. Unlike conventional banks which invest in various types of government papers and private sector instruments, limited shariah compliant investment options essentially means that Islamic banks are largely insulated from the interest rate risks that the rest of the industry is exposed to.

Stress testing results for shocks related to market risks reveal that an increase in interest rates by 200 bps along all the maturities would decrease their CAR by a maximum of 160 bps. Flattening and steepening of the yield curve by a maximum of 150 bps in any maturity bucket would have a lower impact.

Exchange rate exposures of these banks are also not high: four out of six banks have generally had long net open positions (NOP) over the period of analysis, and these banks stand to gain from a potential depreciation in the exchange rate.

Direct equity price risk is pertinent for three banks only since the remaining banks have no investments in shares. The impacts of shocks with a 30.0 percent and 50.0 percent decline in equity prices would be well absorbed by these banks, with a lower impact on CAR. Notably, Islamic banks are allowed higher exposure in equity, and secondly, the stocks in which they can invest are limited in number.[14]

[14] Islamic banks can invest in equity according to the screening criteria laid down by the shariah-advisor, as detailed in the Guidelines for Shariah Compliance, Annexure II, IBD Circular No. 2 dated March 25, 2008 (**Box 8.5**).

8.4 Conclusion

Islamic banking is one of the fastest growing components of the financial sector, despite the challenging environment in which the stand-alone Islamic banks operate, where competitive pressures emanate directly from the conventional banking sector. As the new banks establish themselves in the industry and work toward expanding their deposit and advances portfolio, the Islamic banking industry is expected to continue its penetration into the broader financial sector. With an increased focus of the industry and the regulator on product diversification, extending outreach, strengthening the regulatory framework and the mechanism for shariah-compliance, the Islamic banking industry is well-positioned to meet the target set out in SBP's strategic plan for achieving a market share of 12.0 percent by 2012.

Box 8.5 : Comprehensive Set of Regulations for Shariah-Compliance in Islamic Banking Institutions

One of the landmark developments in the regulatory framework for Islamic banking institutions (IBIs) is the promulgation of a comprehensive set of regulations for Shariah compliance in IBIs issues vide IBD Circular No. 02 dated March 25, 2008. The 'Instructions and Guidelines for Shariah Compliance', issued after consultation with various stakeholders and reviewed and approved by the SBP Shariah Board, complement the directives in the Prudential Regulations and other guidelines issued by SBP.

The 'Instructions for Shariah compliance in IBIs', cover various areas related to the appointment, removal and working of Shariah Advisors; conflict resolution in Shariah rulings; Shariah-compliant modes; Essentials of Islamic Modes, use of charity fund, introduction of new products and services and schedule of service charges. Salient features of these Instructions are as under:

- Every IBI is required to appoint a Shariah Advisor for a renewable term of three years approved by the Board of Directors according to the 'Fit and Proper Criteria for Shariah Advisors' and a clear set of instructions issued by the SBP
- *Fatwa* and rulings of the Shariah Advisor (SA) in all financial matters is deemed to be binding on the IBIs. SA is responsible to review the operations of the IBI on periodic basis in coordination with officials responsible for Shariah compliance, and if any income is declared as non-Shariah compliant by the SA, the same shall be credited to Charity Account opened for this purpose.
- SA is required to prepare a report on the IBI's annual financial statements in respect of its Shariah compliance.
- For conflict resolution in Shariah rulings, decision of the SBP Shariah Board notified by SBP shall be final and SA and IBI may also refer issues to the SBP Shariah Board for decision/guidance.
- A new set of fourteen Shariah compliant modes of finance have been notified as authorized businesses for IBIs in exercise of the powers conferred by section 7(1)(o) of the Banking Companies Ordinance, 1962 providing necessary legal cover to these modes. Annexure-I of BCD Circular No.13 dated 20th June, 1984, wherein 12 modes were prescribed for banks, stands replaced by section 'E' of these instructions insofar as it relates to IBIs.
- In order to define regulations for each Islamic mode of finance, 'Essentials of Islamic Modes of finance' have been prescribed as the minimum requirement for Shariah compliance. Shariah standards issued by Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) may be used as guidelines by IBIs in consultation with their Shariah Advisors for Islamic modes for which these essential requirements have not been prescribed.
- In order to regulate the use of the Charity Fund created for income from non-Shariah compliant sources or late payment charges, etc. a policy is to be formulated, duly vetted by SA and approved by the Board of Directors. However, no portion of the charity fund can be directed to or utilized by persons directly or indirectly connected with the bank and proper record and disclosure is mandated.
- Before launching new products and services, IBIs shall prepare a full set of documents duly vetted by their SA and submit salient features of the product to SBP along with certificate from SA.
- Schedule of Service Charges of IBIs duly signed by SA is to be submitted to the SBP in the prescribed manner.
- Failure to comply with these instructions may invoke penal action under the provisions of Banking Companies Ordinance, 1962

The 'Guidelines for Shariah compliance in IBIs' are meant for providing guidance in areas like Shariah compliance, internal Shariah audit, investments in shares, policy for profit distribution with PLS account holders and financial reporting and general disclosure etc. Necessary flexibility has been provided in these guidelines and IBIs can set up the suggested systems and procedures keeping in view the size and scope of their operations. These guidelines are being issued on "comply or explain basis" and IBIs are required record reasons in writing for non-compliance with any of these guidelines.

Source : Islamic Banking Department, State Bank of Pakistan