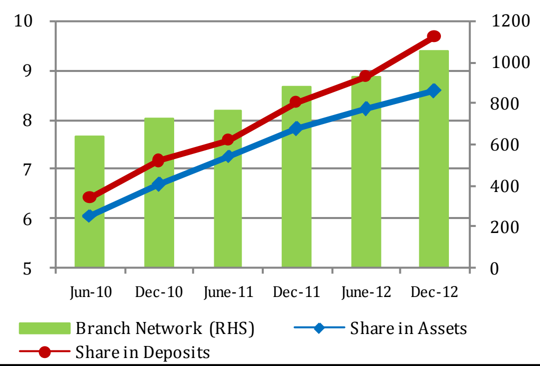
Chapter 4 Islamic Banking

Islamic banking continued a steady increase in its share in the banking sector assets during H2-CY12 that was supported by double digit growth in deposits. In sharp contrast to industry trend, flow of funds was equally distributed among investments and financing activities with a substantial growth in the latter. The Islamic financing, however, remained confined to non-participatory modes for meeting working capital needs, while financing remained meager under participatory modes. The credit risk remained relatively subdued with improvement in asset quality indicators. The liquidity parameters also presented comfortable profile, due to substantial flow of funds into Ijarah Sukuks during H2-CY12. Operating performance somewhat deteriorated as high operating expenses were incurred on robust increase in branch network and related resources. With decline in earning margins, accumulation of retained earnings slowed down that coupled with increase in RWAs dipped the Capital Adequacy of Islamic Banking Institutions.

In line with the robust assets growth pattern during the last ten years, the Islamic banking Institutions (IBIs) continued the momentum in H2-CY12 as its assets surged by 17.6 percent. In fact, the growth of Islamic banking outpaced the growth of conventional banks during the half year[55] and as a result, the share of Islamic banking in total assets of banking sector edged up by 40 bps to 8.6 percent. With PKR 837 billion in assets; Islamic banks approached that of the third largest bank in the industry in terms of assets and deposit base **(Figure 4.1)**.

Figure 4.1

Share of Islamic Banking (in percent)



In contrast to conventional banks that had channeled deposits largely in government securities, Islamic banking observed 18 percent growth in financing activities. The growth in financing actually outpaced increase in investment[56] (**Table 4.1**). However, the operating performance of IBIs somewhat deteriorated due to addition of 130 branches during H2-CY12. As a result network of Islamic banking enhanced to over 1000 branches.

Table 4.1: Growth of Islamic Banking.

	Jun-11	Dec-11	Jun-12	Dec-12	All Banks Dec-12
					PKR billion
Total Assets	560.5	641.0	711.2	836.7	9,760.8
Investments (net)	231.3	274.3	345.7	394.4	4,009.2
Financing (net)	188.6	200.2	196.8	231.3	3,760.3
Deposits	452.1	521.0	602.5	706.5	7,300.7
					precent change
Total Assets	17.5	14.4	10.9	17.6	5.9
Investments (net)	46.6	18.6	26.0	14.1	7.2
Financing (net)	4.6	6.2	(1.7)	17.5	6.7
Deposits	15.9	15.2	15.6	17.3	9.0

In line with the industry trend and established seasonal pattern, most of the financing went to private sector, while that of public sector also improved marginally**.** The corporate sector with 73 percent share in domestic financing remained the key user of Islamic finance. A substantial part of the financing during H2-CY12 met the working capital needs under Murabaha and Istisna modes. While remaining financing channeled into fixed capital purposes under the Diminishing Musharaka (DM) mode of financing. Fresh financing flows during the half year mainly

[55] The assets of the conventional banks grew by 11.8 during H2-CY12.

[56] The share of financing has consistently been declining since last 5 years and it came down from 52 percent in CY08 to 28 percent in CY12.

Figure 4.2

Concentration of Financing as of Dec-12 (in percent)

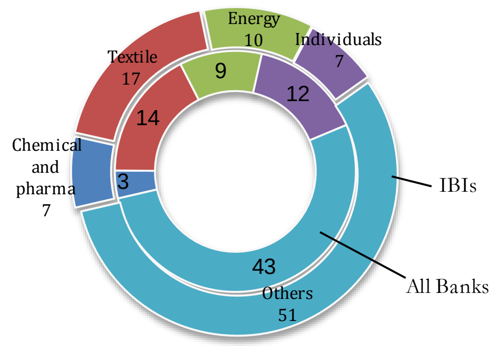


Figure 4.3

Financing Mix as of Dec-12 (in percent)

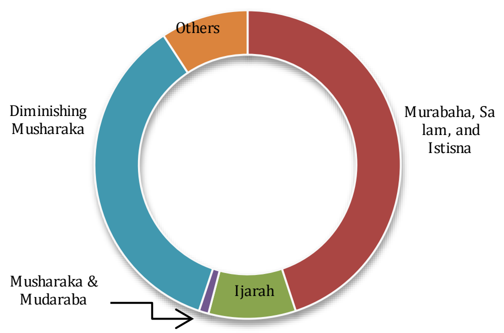
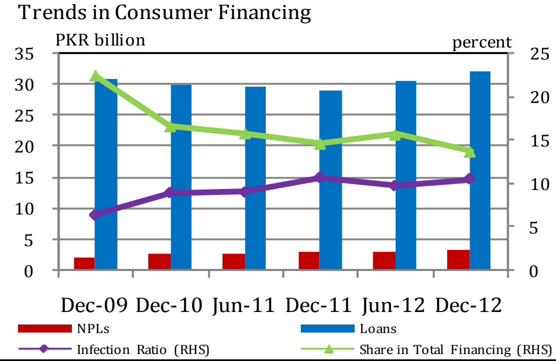


Figure 4.4

Trends in Consumer Financing



catered the financing requirements of textiles, production and transmission of energy and chemical sectors **(Figure 4.2).**

The participatory mode of financing[57] standing at high pedestal in terms of Shariah compliant instruments, have long been considered instrumental in creating real assets and contributing towards economic growth. However, some reluctance by prospective borrowers to undertake profit/loss sharing commitments with the bank and displaced commercial risks[58] hinder the growth of these modes. Accordingly, financing under participatory mode failed to pick-up as most of it went for working capital needs under non-participatory modes. The financing under the Murabaha, Diminishing Musharaka (DM) and the Ijarah constituted about 89 percent of financing mix **(Figure 4.3).** Even after a decade of establishment of first Islamic bank in Pakistan, Musharaka and Modarabas jointly represented merely 1 percent of the total Islamic financing portfolio. To promote the participatory modes of financing, concrete measures are needed at both regulatory front and industry level and needs to be made part of the strategic plan.

Following the footstep of conventional banks, Small and Medium Enterprises (SME) and agriculture remained the most neglected areas in Islamic financing. The share of SME finance dipped by 110 bps to 4.1 percent over the half year, whereas the share of agriculture financing remained abysmally low at 0.1 percent. Such a low level of financing to these important segments of economy call for priority efforts by the Islamic banking industry for exploring these unattended avenues of financing. Keeping in view their importance, State Bank has specified various regulatory guidelines and polices for promoting SME and agriculture financing, which can be utilized for extending Shariah complaint financing.

Consumer finance, the second major user of Islamic funds, witnessed a meager 4 percent growth in financing during H2-CY12 mainly on account of auto-financing under car Ijarah and DM modes. Rest of the consumer finance segments, with minor changes, remained almost static during the half year **(Figure 4.4).**

Deposits growth remained robust….

[57] Islamic modes are asset based and they create real economic activities or liabilities. The participatory mode of financing refers to the profit and loss sharing techniques under various methods including Modarabas, Musharaka and Diminishing Musharaka.

[58] The risk held by the shareholders of the Islamic bank in order to cushion / protect the Investment Account Holder (IAH) from bearing some or all of the risks arising from engaging in participatory modes of financing.

Figure 4.5

Customer Deposits

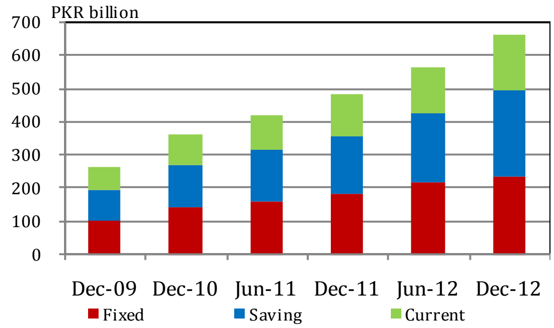


Figure 4.6

Growth in Advances and Deposits (in percent)

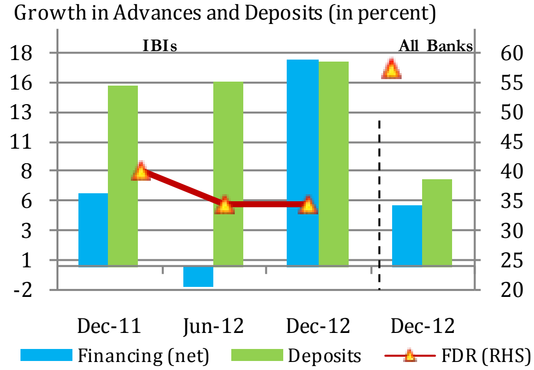


Figure 4.7

Liquidity Ratios (in percent)

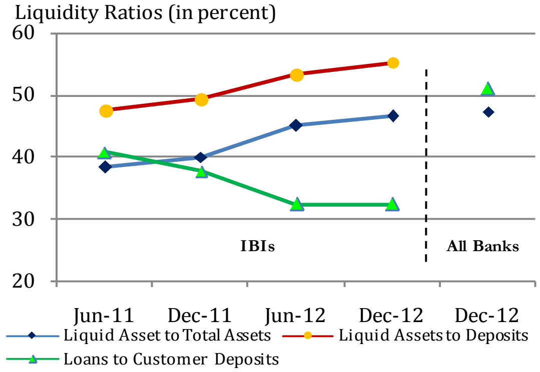


Table 4.2: Asset Quality

				in percent
	IBIs			All Banks
	Dec-11	Jun-12	Dec-12	Dec-12
NPF to Financing	7.6	8.8	7.6	14.5
Net NPF to Financing	2.9	3.8	2.7	4.6
Provisions to NPFs	63.0	59.5	66.5	71.8
Net NPFs to Total Capital	10.5	12.6	9.8	19.4
	IBs		IBBs	
	Jun-12	Dec-12	Jun-12	Dec-12
NPF to Financing	11.5	9.2	4.3	4.3
Net NPF to Financing	4.4	2.9	2.8	2.3
Provisions to NPFs	64.4	70.5	36.9	48.5
Net NPFs to Total Capital	13.7	10.8	10.5	8.0
NPFs (PKR billion)	15.0	15.1	3.3	3.4

IBs=Islamic Banks, IBBs = Islamic Banking Branches, IBIs = IBs+IBBs

The deposit base of the IBIs observed robust growth of 16.7 percent over the half year, mainly contributed by Modarabas based saving deposits and Qurd based current accounts **(Figure 4.5)**. The efforts of Islamic banks in expanding their outreach and utilization of the existing branch network by IBBs remained the driving force behind the consistent increase in deposits. However, deposits products being offered by IBIs faced with non-standardized computation of profit and loss and distribution policies. Promulgation of the "Instructions for Profit & Loss Distribution and Pool Management for Islamic Banking Institutions[59]" can be well regarded as the milestone in addressing the issue. The long awaited instructions would not only bring uniformity in industry practices but is also expected to boost the confidence of general public in Islamic Banking. Realization of objective of these guidelines is yet to be observed in days to come.

Consistent and high financing needs of the government due to fiscal slippages and subdued flow of credit to private sector; allowed IBIs to invest fresh funds into sovereign securities at attractive rates. During last five years, the government issued Ijarah Sukuks worth PKR 501 billion. The trend continued during the period under review as IBIs added another 14.6 percent Ijarah Sukuks during H2-CY12[60]. Consequently, liquidity indicators improved further during period under review as liquid asset to total asset and liquid asset to deposit ratio at 46.6 percent & 55.3 percent respectively approached the corresponding ratios of conventional banking. However, it also kept the financing to Deposit ratio dismally low at 32.4 percent as against 51.0 percent in conventional banks **(Figures 4.6 and 4.7)**.

The concern with respect to the upward momentum of Non Performing Finances (NPFs) of IBIs observed over the last five years alleviated a little bit as asset quality slightly improved over the period under review (**Table 4.2**). Negligible increase in NPFs during H2-CY12 coupled with healthy growth in financing, improved the asset quality indicators. The lower infection rate of IBIs relative to overall banking industry, reflect their ability to better manage the credit risk. The provisions coverage improved by 7 percentage points to 66.5 percent, which enhanced the cushion available to IBIs to sustain the credit losses. As a result, Capital at risk (Net NPFs to total Capital) of IBIs dropped to 8

[59] IBD Circular No. 3 dated November 19, 2012

[60] During H2-CY12, there was only one GoP Ijara Sukuk auction in which offer to target ratio was 2.45, much higher than 1.64 for H1-CY12 showing enormous interest of banks towards investing in risk free Islamic mode of government securities.

Figure 4.8

IBIs' Earnings and Expenses

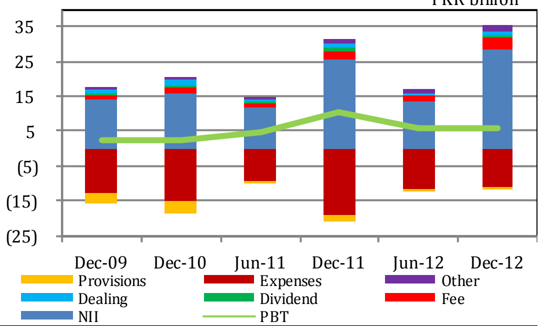


Figure 4.9

Sources of earnings

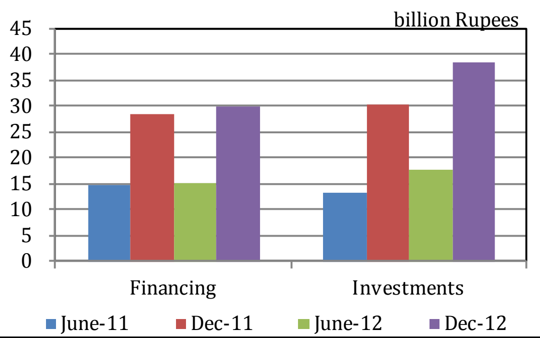


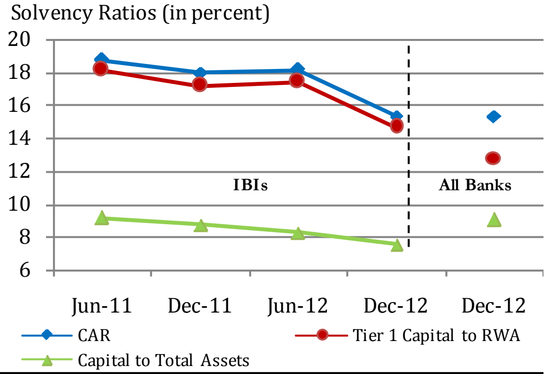
Table 4.3: Earnings (in percent)

	IBIs				All Banks
	Jun-11	Dec-11	Jun-12	Dec-12	Dec-12
Return on Assets	2.0	1.9	1.8	1.4	2.0
Return on Equity	20.7	20.8	20.6	16.8	22.1
Operating Expenses to Gross Income	60.9	60.4	64.7	67.3	53.9

Profit before tax is used in all calculations

Figure 4.10

Solvency Ratios (in percent)



percent during CY12 as against 19.4 percent of the banking industry.

The earning of IBIs that experienced consistent growth over the years came under stress due to high operating expenses. The PBT witnessed year on year decline of 6.3 percent to PKR 9.9 billion during CY12 **(Figure 4.8)**. In parallel with the conventional banks' return on the high yielding government Sukuks buttressed the IBIs profitability and provided for major chunk of the earnings **(Figure 4.9)**. However, administrative expense soared by 27 percent in the H2-CY12, which marginally deteriorated the full year earnings. As a result, operating expense to income ratio inched up to 67.3 percent up from 60.4 percent in the corresponding period of last year. This weakening along with decline in the NIM due to deceleration in return income led to a decline in both the ROA and the ROE on the IBIs **(Table 4.3)**.

While soaring administrative expense and corresponding high expense ratio raised concerns on efficient operations of the IBIs, a robust increase in branch network and related expenses provided the very basis for this surge. In fact, rapid expansion in branch network is indicative of demand for Islamic banking products and services that allowed the IBIs to post phenomenal growth in assets base (average 30 percent growth over the last 5 years). As such, the efficiency ratios of the industry are expected to remain high for some years to come.

The Capital Adequacy Ratio of Islamic Banks[61] observed dip of 2.78 percentage points to 15.4 during H2-CY12, mainly on account of increase in Credit Risk Weighted Assets (CRWA) and slow down in accumulation of retained earnings. The CAR at the prevailing level remained well above the required regulatory benchmark. The better CAR indicators suggest the risk averse behavior of the IBIs with significantly larger investments in low risk government securities. All of the Islamic Banks maintained capital adequacy above the required level, though most of them continued to face challenges in meeting the MCR of PKR 9 billion **(Figure 4.10)**.

[61] Represent CAR of Islamic banks only.