Chapter 4 Islamic Banking

The increase in assets base of Islamic banking continued to outpace the growth in banking sector of Pakistan as share of Islamic banking reached 9 percent during H1-CY13. In sharp contrast to industry trend, flow of funds for financing activities outpaced investments. The financing was broad based with major portion extended for long-term investment under Ijarah and Diminishing Musharakah, while Musharakah financing saw a substantial surge. The assets quality indicators showed marginal improvement though Non-Performing Financing saw some increase. The earning performance moderated due to higher provision charge and increasing operating expenses largely incurred on expansion of outreach. The Capital adequacy with marginal improvements remained steady.

Figure 4.1

Share and Network of Islamic Banking

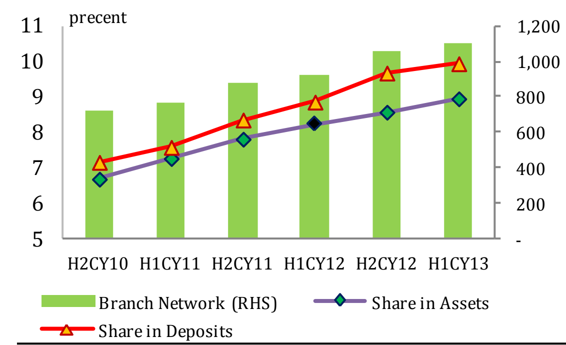


Table 4.1: Growth of Islamic Banking.

					PKR billion
	Dec-11	Jun-12	Dec-12	Jun-13	All Banks Jun-13
Total Assets	641	711	837	903	10,090
Investments (net)	274	346	394	439	4,253
Financing (net)	200	197	231	261	3,727
Deposits	521	603	771	771	7,756
					precent change
Total Assets	14.4	10.9	17.7	7.9	3.4
Investments (net)	18.6	26.0	14.1	11.3	6.1
Financing (net)	6.2	(1.7)	17.5	12.8	(0.9)
Deposits	15.2	15.6	27.9	9.1	6.2

Islamic banking continue gaining weight globally………

Islamic banking has been the major driver of Islamic finance over the last decade and has started to gain systemic importance. It expanded at a Compound Average Growth Rate (CAGR) of 19.1 percent during 2007-2012 enhancing the Islamic banking assets to around USD 1.28 trillion[39].

….and so is the case with Islamic banking in Pakistan

Islamic banking in Pakistan continued its expansion in terms of size and penetration during H1CY13 though at decelerated pace (**Figure 4.1**). With 7.9 percent increase in assets, share of Islamic banking edged up by 40 bps to 9 percent. Though both financing and investment activities contributed to this growth, the former not only observed double digit surge but also outpaced investment activities for second half-year in a row. Investment activities remained largely confined to investment in Government Ijara Sukuks. The operating performance of Islamic Banking Institutions (IBIs) somewhat deteriorated due to higher provisions charge and soaring operating expenses (**Table 4.1**).

Deposits continued to provide required funding…

Deposits remained the key funding source for the Islamic Banking institutions (IBIs). The efforts of IBIs in expanding their outreach and utilization of the existing branch network remained the driving force behind the consistent increase in deposit base. The deposit base of IBI's increased by 9.1 percent during H1CY13, financing the essential expansion in Islamic banking assets. The customer's deposits at around 95 percent of deposits provided stabile source of funding (**Figure 4.2**). The mix of Mudarbah (saving and term) and Qurd (current) deposit

[39] IFSB; Islamic Financial Industry Stability Report, 2014

Figure 4.2

Customer Deposits

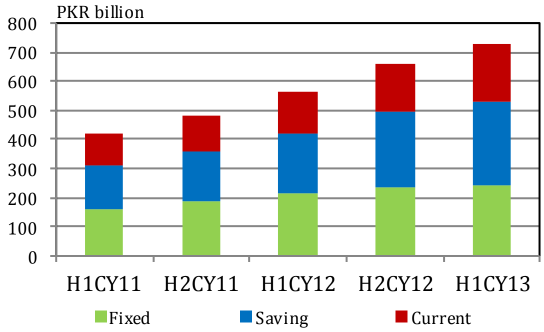


Figure 4.3

Private sector borrowers continued to grow ('000)

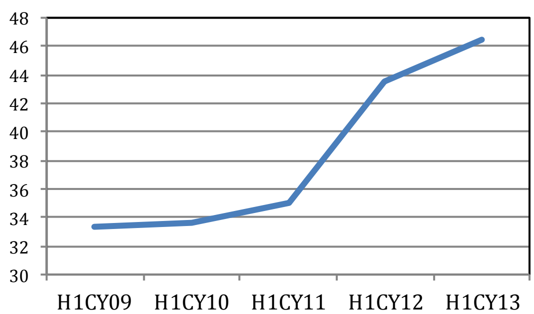


Table 4.2: Islamic modes of financing

PKR billion

	H1CY12	H2CY12	H1CY13	Growth(%)
Murabaha	75.1	85.4	97.6	14.3
Salam	7.4	7.3	13.4	82.8
Istina	10.8	17.7	15.1	(14.9)
Musharaka	2.4	1.9	4.0	108.6
Car Ijara	9.4	10.9	10.1	(7.7)
Plant and machinery Ijara	6.4	4.8	4.9	2.6
Equipment Ijara	5.7	5.9	6.7	13.0
Others Ijara	1.2	0.6	1.5	149.5
Diminishing Musharaka	74.2	87.1	90.2	3.7
Islamic Export refinance	8.8	11.8	12.6	6.7
Mudarabah	0.2	0.6	0.5	(19.7)
Other Islamic modes	6.7	10.9	18.6	70.9
Total	**208.4**	**244.9**	**275.2**	**12.4**

respectively at 69 and 26 percent remained in conformity with past trend and in alignment with overall business conduct of IBI's.

Financing remained robust and relatively broad based…

Keeping the pace with development in H2CY12, growth in financing at 12.8 percent remained ahead of investment growth of 11.3 percent. As such, share of financing, which was on downhill for last 5 years[40], increased by 123 bps to 29 percent. Private sector remained the prime user of the funds, with additional funds channeled to more diverse borrower categories (**Figure 4.3**). While public sector, with a mere 11 percent share of financing, observed surge of 59 percent, largely for financing the public sector commodity procurement operations.

Corporate sector utilized major part of the flows during H1-CY13 largely for long-term investment and trade financing needs. In terms of Islamic modes, the period under review observed some encouraging trends. Musharakah financing (sharing based mode) observed more than 100 percent increase to Rs 4.4 billion, while considerable financing under Ijara and Diminishing Musharakah (DM) was directed towards fixed capital formation. Additionally, banks ventured into financing commodity procurement operations under Murabaha financing. Salam financing also increased by 82 percent for financing trade and agribusiness related activities (**Table 4.2**). Fresh financing flows during the half year catered the financing requirements of textiles, chemical sector, and production and transmission of energy.

Despite improvements in credit flows, the share of trade related modes lead the financing landscape of Islamic banking. The financing under the Murabaha, Dimnishing Musharakah and the Ijarah composed about 86 percent of financing mix (**Figure 4.4**). To encourage the participatory mode of financing, IBI's needs to refocus on asset led strategic policy by exploring the sharing based financing avenues. To this end, regulator is continuously making efforts for bringing about improvements in shariah compliance framework and harmonization of industry practices. During the period under review, SBP issued instruction for extending facilities in conformity with the various AAOIFI and shariah standards[41].

[40] Share of Financing came down from 52 percent in CY08 to 28 percent in CY12.

[41] IBD Circulars No.1, 2 and 3 of 2013; see URL; http://www.sbp.org.pk/ibd/2013/index.htm

Figure 4.4

Financing Mix (in percent)

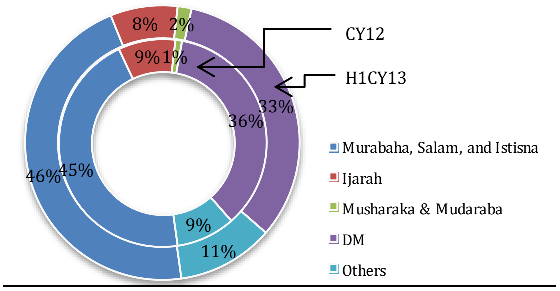
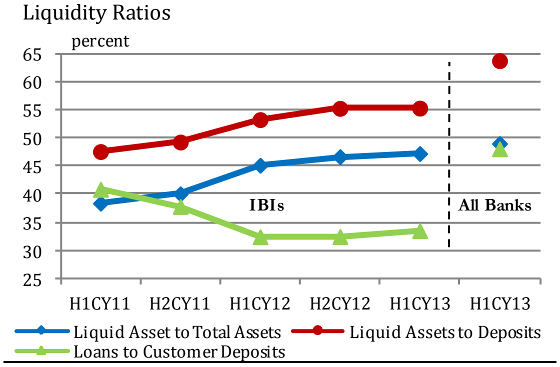


Table 4.3: Segement wise financing				
				PKR million
	H1CY12	H2CY12	H1CY13	Growth(%)
Corporate Sector:	146.5	179.0	192.9	7.8
Fixed Investment	63.7	76.9	82.1	6.7
Working Capital	71.6	89.4	88.8	(0.7)
Trade Finance	11.2	12.6	22.0	74.7
SMEs:	10.8	10.1	10.2	1.2
Fixed Investment	2.9	2.5	3.5	42.4
Working Capital	5.8	6.4	5.3	(16.2)
Trade Finance	2.1	1.2	1.3	8.0
Agriculture	0.1	0.2	0.2	21.6
Consumer Finance:	30.8	32.0	35.1	9.6
Commodity Financing	15.3	17.8	29.7	66.5
Others	4.6	4.5	5.4	19.92
Total	208.2	243.7	273.6	12.3

Figure 4.5

Liquidity Ratios



In line with the industry trend, consumer-financing portfolio of IBIs observed steady increase. This second major user of Islamic funds witnessed a growth of 10% percent, with most of disbursement confined to auto-financing and mortgages under car Ijara and DM modes. Rest of the consumer finance segments, with minor changes, remained almost static during the half year (**Table 4.3**). The share of SME and Agriculture in IBI's financing portfolio remained quite meager at about 4 percent, despite various regulatory measures for promoting SME and agriculture financing.

..while investments largely confined to Ijrara Sukuk

Over the last few years high fiscal needs of the government along with subdued credit flow to private sector and steady growth in deposits allowed IBIs to invest considerable amount of funds in Government Ijara Sukuks at attractive rates. The trend continued during the H1CY13, as IBIs added another 12.9 percent Ijarah Sukuks, increasing their volume to PKR 314.6 billion. Consequently, liquidity indicators improved further during the period under review as liquid asset to total asset and liquid asset to deposit ratio at 47.2 percent & 55.3 percent respectively reached the corresponding ratios of conventional banking. However, it also kept the financing to deposit ratio dismally low at 33.5 percent as against 47.5 percent in conventional banks (**Figure 4.5**).

Liquidity management a major challenge for the industry…

Though GoP Ijara Sukuk provides Islamic banks with long-term liquidity management instruments, development of innovative Shariah compliant short maturity liquidity management instrument remains the major challenge. Inherent characteristics of Islamic modes of financing & deposit structures in wake of limited supply of the interbank liquidity instruments renders IBI's more vulnerable to liquidity risk compared to conventional banks. The SBP is working on developing such an instrument in collaboration with the industry. In the meantime, IBIs need to improve the fund management practices by diversifying the assets and the corresponding liabilities structures.

Asset quality improved marginally……

The asset quality of the loan portfolio continued to improve during the period under review though Non-performing Financing (NPFs) observed some increase. Both NPFs to financing and Net NPFs to Net Financing declined during H1CY13 as growth in financing outpaced growth in NPFs. Provisions

Table 4.4: Asset Quality						
	IBIs					All-Banks
	H1CY11	H2CY11	H1CY12	H2CY12	H1CY13	H1CY13
NPF to Financing	7.5	7.6	8.8	7.6	7.1	14.8
Net NPF to Financing	3.2	2.9	3.8	2.7	2.5	4.4
Provisions to NPFs	60.0	63.0	59.5	66.5	66.1	73.2
Net NPFs to Capital	14.3	10.2	13.4	11.1	12.2	19.4
	IBs			IBBs		
	H1CY12	H2CY12	H1CY13	H1CY12	H2CY12	H1CY13
NPF to Financing	11.5	9.2	8.7	4.3	4.3	3.9
Net NPF to Financing	4.4	2.9	2.9	2.8	2.3	1.9
Provisions to NPFs	64.4	70.5	69.2	36.9	48.5	52.3
Net NPFs to Capital	14.6	12.3	14.5	11.0	9.0	8.0

Figure 4.6

IBIs' Earnings and Expenses

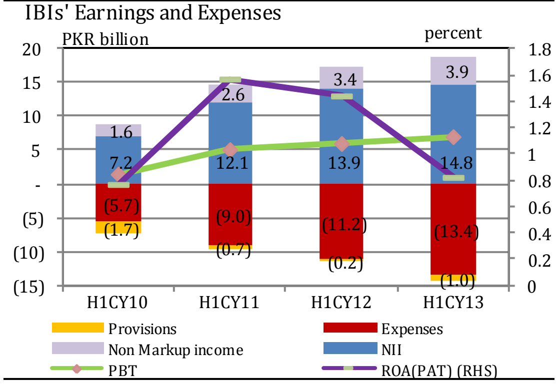
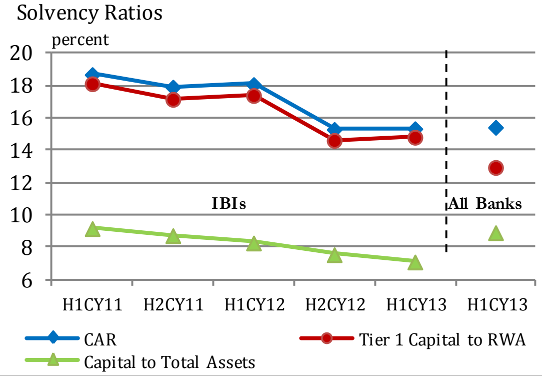


Figure 4.7

Solvency Ratios



coverage ratio with a marginal dip remained steady at 66.1 percent. Capital at risk (Net NPFs to total Capital) inched up to 12.2 percent due to slow pace of growth in capital, though remained far below the industry average of 19.4 percent (**Table 4.4**).

Earning of IBIs moderated somewhat ……..

The profitability of IBIs deteriorated during H1CY13 owing to persistent rise in the high operating expenses and sharp increase in the provision expenses. The profit before tax (PBT) witnessed YoY decline of 27 percent to PKR 4.3 billion. As a result, the ROA of the IBIs declined to 0.8 percent in H1CY13 compared to 1.4 percent in corresponding period last year **(Figure 4.6)**

In addtion to four times increase in provisions charge due to higher NPFs, non-mark-up expense increased by 20 percent during the period under review. Accordingly operating expense to income ratio inched up to 71.7 percent. Although escalating administrative expense raises concerns on efficient operations of the IBIs, however, robust increase in branch network and related resources provide the very basis for this surge. As such, we can expect the efficiency ratios of the industry may remain high for some years to come. However, soaring provision expenses in lieu of restrained chunk of finance portfolio suggest serious operational deficiencies on part of the IBI's.

The overall CAR of the Islamic Banks[42] with minor imporvements remained unchaged at 15.4 during H1-CY13 **(Figure 4.7)**. Analysis of components show that eligible capital as well as Risk weighted assets increased by 2 percent each; increase in capital resulted from accumulation of retained earnings and increase in paid up capital post announcement of annual results; while growth in Risk Weighted Assets came from 50 percent increase in MRWA. All Islamic Banks maintained CAR well above the required level, though some of them face challenge in meeting the MCR of PKR 9 billion.

[42] Represent CAR of Islamic banks only.