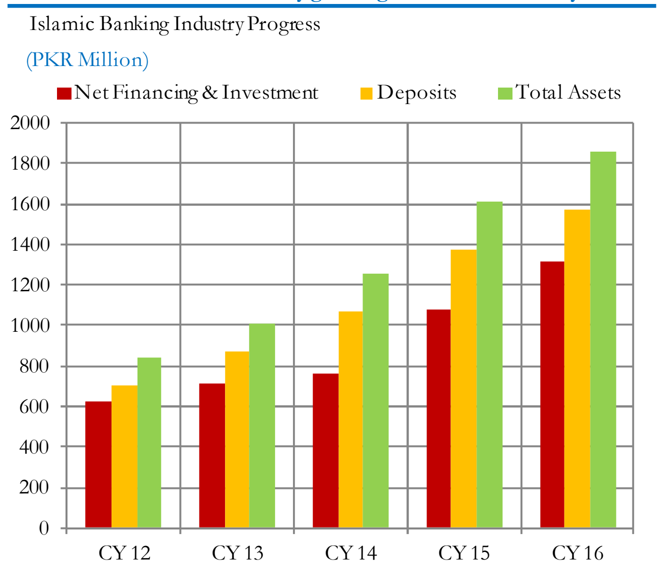
3.2 Risk Analysis of the Islamic Banking

Islamic Banking continues its double digit growth as the assets share of the sector reaches 11.70 percent of the total banking industry's assets. Healthy growth in financings mainly in Diminishing Musharaka and Musharaka supported overall increase in the assets. Diminishing Musharaka has continued to dominate the share in financing followed by Murabaha, Musharaka, Istisna and Ijara. The credit risk has remained subdued with improvement in asset quality indicators. The investment growth has remained subdued due to low frequency of Sukuk issuance coupled with maturity of Bai Muajjal Sukuk transaction of Islamic Banking Institutions (IBIs) with the GOP. Resultantly, liquidity management poses challenges for IBIs. The earnings have moderated due to declining spread and higher operating cost. Capital adequacy has remained above the required level, despite slight decline due to considerable increase in financing. The prospects for IBIs are encouraging due to supportive supervisory framework, positive economic outlook and significant energy and infrastructure projects in the pipeline.

The global Islamic Banking industry's growth has remained stagnant in 2016 largely due to exchange rate fluctuations with respect to US dollar.[105] However, the domestic market share of Islamic banking in relation to total banking sector increased in large number of countries, and Pakistan is no exception. The growth trend of Islamic banking industry in the country has continued, albeit with some moderation (**Figure 3.2.1**).

Figure 3.2.1

Islamic Banks showed a steady growing trend over the last 5 years.



Source: FSD, SBP

Quite in line with the conventional banking sector, most indicators of Islamic Banking Institutions (IBIs) have also exhibited moderate growth in comparison with the previous year's performance.

The total Assets, Investments (net), Financing (net) and Deposits of IBIs have increased by 15.09 percent, 13.45 percent, 27.21 percent and 14.44 percent respectively, during CY16. This growth may seem modest as compared to the previous year, but the results are still encouraging as compared to conventional banking industry **(see Table 3.2.1)**.

Table 3.2.1

Performance of Islamic Banking

	IBIs			Conv. Banks	
	CY14	CY15	CY16	CY15	CY16
	PKR billion				
Total Assets	1,258.8	1,610.0	1,852.9	12,533.2	13,978.1
Investments (net)	356.7	431.9	490.0	6,448.9	7,019.2
Financing (net)	408.8	645.3	820.9	4,170.5	4,677.9
Deposits	1,069.7	1,374.8	1,573.3	9,014.5	10,224.5
	percent (YoY)				
Total Assets	24.15	27.90	15.09	15.54	11.53
Investments (net)	(9.54)	21.07	13.45	30.20	8.84
Financing (net)	29.75	57.86	27.21	3.27	12.17
Deposits	23.28	28.52	14.44	10.47	13.42

Source: FSD, SBP

105 IFSB, "Islamic Financial Services Industry Stability Report", 2017. For more details, please see Table 1.1.1 and its explanatory note on page 7 in the IFSB's report.

IBIs assets have reached PKR 1,852.9 billion which is 11.70 percent of the asset base of the overall industry, registering a slight increase from 11.38 percent in the previous year.

The SBP's 5 year Strategic Plan for Islamic Banking industry (2014-2018)[106], inter alia, envisages Islamic banking industry to achieve a target of 2000 branches and 15.0 percent share by the end of 2018. The branch expansion target has already been achieved in CY15. In CY16, the branch network[107] of IBIs has further expanded by 247 branches to 2,322 branches (**Figure 3.2.2**). On the other hand, given the current gap and moderate pace of growth in share of Islamic banking industry, achievement of the share target of 15 percent by 2018 seems challenging.

Financing growth of IBIs outpaces the industry…

In terms of growth in financing, IBIs' have fared well; their financing growth of 27.21 percent has been higher than conventional banks (12.17 percent).The surge in financing has been conspicuous in the last quarter of CY16 especially in the aftermath of maturity of Bai Muajjal sukuk transaction of IBIs with GOP.

Private sector obtained the major chunk of IBIs financing…

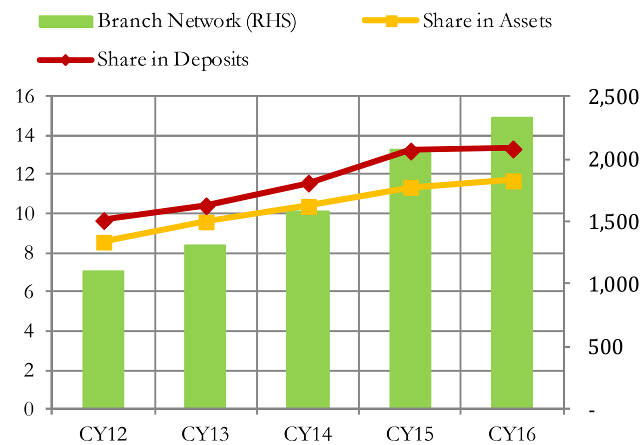
Private sector has remained the major recipient of IBIs financing as outstanding financing to private sector has been recorded at PKR 719.7 billion. Textiles and production and transmission of energy have been the major users of IBIs financing in the private sector. However, these sectors also expose IBIs to concentration risk. Further, financing of PKR 130.9 billion have been provided to the public sector wherein production and transmission of energy has received the major chunk. This huge rise is attributed to energy sector projects being pursued in the public sector.

Figure 3.2.2

Share and network of Islamic Banking continued to grow

Share and Network of Islamic Banking

(amount in numbers, ratios in percent)



Source: FSD, SBP

Diminishing Musharaka continues to dominate the modes of financing…

In line with the trend set in CY15, Diminishing Musharaka (DM), with 34.71 percent share in overall financing by IBIs, continues to dominate the share in modes of financing. This rising trend of DM is indicative of IBIs' tendency towards financing for longer term projects. Financing under Murabaha has 15.79 percent share and the combined share of Ijara, Salam and Istisna comprises almost 19.60 percent of the financing portfolio of IBIs (**Table 3.2.2**). Among participatory modes of financing, Musharaka increased to 15.63 percent of the total financing.

[106] http://www.sbp.org.pk/Departments/Pdf/Strategicplanpdf/Strategy%20Paper-Final.Pdf

[107] Currently 21 Islamic Banking Institutions (IBIs) including 5 full-fledged Islamic banks and 16 conventional banks having Islamic banking branches (IBBs) are operating in the country with a network of 2,322 branches across 112 districts.

Table 3.2.2

Islamic modes of financing

	CY13	CY14	CY15	CY16
	(percent share in total financing)			
Murabaha	40.63	30.12	24.55	15.79
Salam	4.04	4.54	5.33	4.36
Istisna	5.59	8.34	8.63	8.40
Musharaka	6.65	11.02	13.99	15.63
Ijara	7.70	7.65	6.58	6.84
Car Ijara	4.85	5.27	4.17	4.45
Plant and machinery Ijara	1.61	1.48	1.40	1.32
Equipment Ijara	0.54	0.31	0.08	0.13
Others Ijara	0.69	0.59	0.92	0.95
Diminishing musharaka	30.83	32.62	31.71	34.71
Other Islamic modes of finance	4.39	5.64	9.17	14.23
Mudarabah	0.15	0.05	0.03	0.01
Qard/Qard-e-Hasan	0.01	0.01	0.01	0.02
Total	100.00	100.00	100.00	100.00

Source: FSD, SBP

To encourage participatory modes of financing by IBIs, SBP has allowed them to avail the exemption from the requirement of using KIBOR as benchmark rate for financing provided on the basis of participatory (Musharakah & Mudarabah) and Wakalah (Agency) modes.[108] Instead, they can design their own mechanism for pricing under these modes. Besides encouraging financing, this policy action is expected to address perception related issues for Islamic banks.

Corporate sector remains the main recipient of IBIs funds…

In line with the historical trend, client-wise financing of IBIs has remained concentrated in corporate sector (PKR 658.8 billion and 77.45 percent of gross financing). Corporate sector seems to have capitalized on the low markup environment as corporate sector financing has registered a growth of 30.89 percent. In comparison, advances to the corporate sector by the conventional banks, at PKR 3,117.0 billion and 66.26 percent of gross loans, have grown by 11.93 percent during the same period.

Within the corporate sector, PKR 339.54 billion (51.54 percent of corporate financings) has been utilized for fixed investment in CY16 as against PKR 215.07 billion (42.73percent) in CY15. PKR 260.42 billion (39.33 percent of corporate financings) of the funds are utilized for working capital needs and PKR 58.84 billion (or 8.93 percent of corporate financings) for trade financing (**Table 3.2.3**).

Share of SME and Agriculture financing rises …

Although, SME and Agriculture financing constitute only 4.22 percent share in total financing, SME has grown by 39.41 percent and Agriculture by 58.60 percent in CY16.

The rise in growth of SMEs and Agriculture financing can also be attributed to SBP's endeavors towards promoting such financing by allocating indicative financing targets to banking industry (including IBIs).

Table 3.2.3

Segement wise financing

	CY13	CY14	CY15	CY16	Growth
	PKR billion				percent
Corporate Sector:	236.2	327.0	503.3	658.8	30.89
Fixed Investment	94.5	138.8	215.1	339.5	57.87
Working Capital	109.3	148.1	228.7	260.4	13.85
Trade Finance	32.4	40.1	59.5	58.8	(1.16)
SMEs:	16.8	15.1	20.8	29.0	39.41
Fixed Investment	5.2	5.4	6.0	7.4	24.78
Working Capital	2.9	1.3	13.2	20.3	53.15
Trade Finance	8.6	8.4	1.6	1.4	(17.92)
Agriculture	0.3	1.8	4.3	6.8	58.60
Consumer Finance:	38.2	50.5	67.7	89.7	32.63
Commodity Financing	31.6	22.7	58.2	47.4	(18.55)
Staff Loans	5.2	6.8	8.8	10.0	14.15
Others	0.8	1.5	13.9	8.8	(36.71)
Total	329.1	425.4	677.0	850.6	25.65

Source: FSD, SBP

108 IBD Circular No.1 of 2016
http://www.sbp.org.pk/ibd/2016/C1.htm

Consumer financing grows significantly …

In view of narrowing profit margins, IBIs have enhanced focus on consumer financing. As a result, it has registered an increase of 32.63 percent (YoY). Incidentally, the consumer portfolio of conventional banks has witnessed an increase of 6.25 percent (YoY) **(Table 3.2.4)**.

Particularly, the IBIs have outperformed conventional banks in Mortgage financing which has registered a growth of 28.98 percent (YoY) compared to 16.05 percent growth by conventional banks. Out of total mortgage financing of PKR 53.5 billion by banking industry in CY16, the share of IBIs has amounted to PKR 32.3 billion or 60.33 percent. Similarly, growth of auto financings of IBIs at 35.54 percent is above the conventional bank's auto loans growth of 30.01 percent (YoY) (**Table 3.2.4**).

Table 3.2.4
Consumer Financing

	IBIs		Conv. Banks	
	CY15	CY16	CY15	CY16
	PKR Billion			
Total Consumer Finance	67.66	89.73	256.45	272.46
Credit Card	0.29	0.37	24.23	27.80
Auto Financings	40.34	54.68	54.71	71.12
Consumer Durable	0.25	0.24	0.08	0.08
Mortgage Financings	25.01	32.26	18.28	21.21
Other Personal Financings	1.76	2.17	159.16	152.26
	percent (YOY)			
Total Consumer Finance	33.87	32.63	11.23	6.25
Credit Card	27.81	28.76	8.10	14.74
Auto Financings	35.20	35.54	33.33	30.01
Consumer Durable	(4.58)	(2.42)	(8.50)	(2.43)
Mortgage Financings	31.53	28.98	(12.46)	16.05
Other Personal Financings	47.36	23.39	8.91	(4.33)

Source: FSD, SBP

Growth in Investments of IBIs slows down…

The investment portfolio of IBIs, mostly comprising GoP Ijara Sukuk, has grown at a moderate pace of 13.45 percent during CY16 compared with 30.2 percent in CY15 (**Table 3.2.5**). This deceleration in investments is mainly attributed to lack of adequate supply of sukuk instruments by the government coupled with the maturity of Bai Muajjal sukuk transaction of IBIs with the government. This made it quite challenging for IBIs to meet the SLR requirements. To address this issue, SBP has announced reduction of SLR for IBIs from 19 percent to 14 percent in November 2016.[109]

Nonetheless, the growth in investments of IBIs in CY16 is higher than the growth of 8.84 percent recorded in similar portfolio of the conventional banks.

Table 3.2.5
Investments

	CY13	CY14	CY15	CY16	Growth
	PKR billion				percent (YoY)
Federal Government Securities	266.7	240.5	307.4	356.5	15.97
Fully paid up ordinary shares	4.3	5.4	12.0	18.8	55.67
Bonds/ PTCs/Sukuk certificates	34.0	45.1	56.7	86.3	52.32
Other investments	90.9	67.3	62.5	34.6	(44.62)
Total Investments	395.9	358.2	438.7	496.2	13.13
Provisions & deficit/ (surplus)	(1.5)	(1.5)	(6.7)	(6.3)	(7.37)
Investments (net)	394.4	356.7	431.9	490.0	13.45

Source: FSD, SBP

Deposits, the key funding source of IBIs, continue the growth momentum…

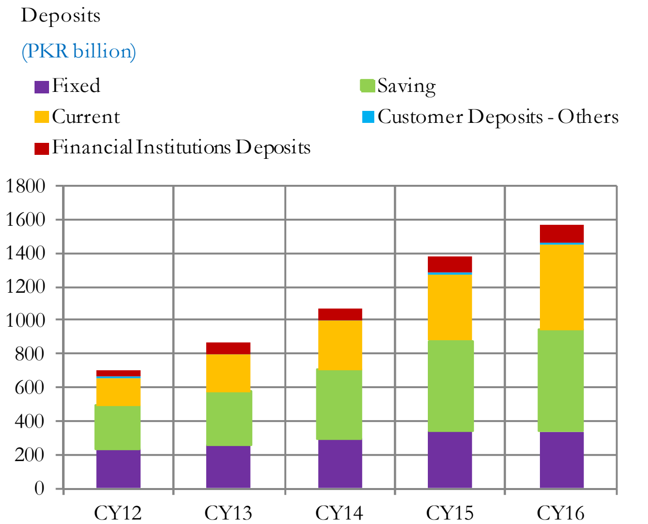
Deposits remain the main funding source as IBIs maintain their deposit growth albeit with moderation. Nevertheless, deposit growth of 14.44 percent is still marginally ahead of 13.42 percent growth of deposits of the conventional banks. Moreover, IBIs deposits at current level of PKR 1,573.3 billion constitute 13.34 percent of the banking industry's deposits.

109 DMMD Circular No.16 of 2016
http://www.sbp.org.pk/dmmd/2016/C16.htm

Customer deposits, at 92.96 percent of total deposits, provided the base for the expansion in Islamic banking assets as it grew by 13.97 percent in CY16. Within customer deposits category, Savings and Fixed deposits (generally, Mudaraba based), having a combined share of 59.85 percent, have grown by 7.14 percent. Current deposits (generally, Qard based), having a share of 32.09 percent, have increased by 28.94 percent (**Figure 3.2.3**).

Figure 3.2.3

Deposits maintain growth momentum



Source: FSD, SBP

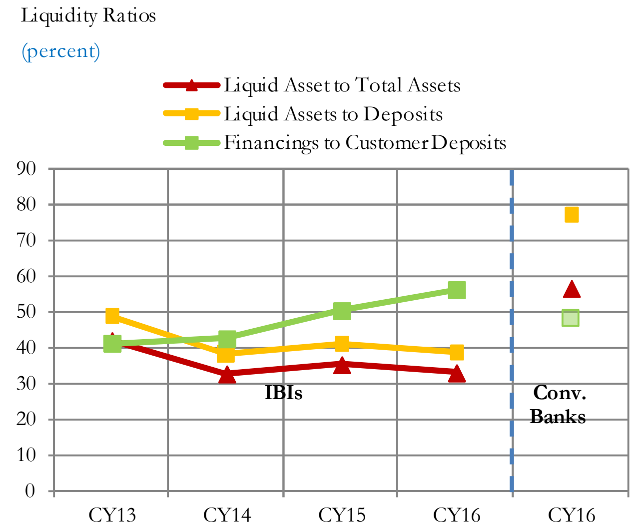
But, fund based liquidity profile of IBIs demand further attention…

The liquidity profile, however, poses a challenge for IBIs. Despite having sufficient resources (deposits), the stock of liquid assets with IBIs is low. Liquid Assets to Total Assets and Liquid Assets to Total Deposits are currently at 32.91 percent and 38.95 percent, respectively, for IBIs compared with 56.49 percent and 77.23 percent for conventional banks (**Figure 3.2.4**).

This is because lack of approved Shariah compliant instruments induces IBIs to place their surplus funds elsewhere. IBIs have higher balances with other banks and higher amounts due from financial institutions as compared to their conventional counterparts which have high investments in government securities (**Table 3.2.6**).

Figure 3.2.4

Liquidity ratios decline



Source: FSD, SBP

Table 3.2.6

Structure of IBIs vs Conventional Banks

	IBIs		Conv. Banks	
	CY15	CY16	CY15	CY16
	Share in Percent			
Cash and Due from treasury Banks	7.25	7.97	6.32	7.42
Balances with other banks	3.91	2.17	1.08	0.92
Due from Financial Institution	16.25	14.35	0.79	2.04
Investments-net	26.83	26.44	51.45	50.22
Financing-net of provision	40.08	44.30	33.28	33.47
Fixed Assets	1.67	1.75	2.26	2.17
Deferred Taxes	0.59	0.53	0.45	0.39
Other Assets	3.42	2.47	4.37	3.37
Total assets	100.00	100.00	100.00	100.00

Source: FSD, SBP

IBIs focus on financing side is also evident from their Financing to Deposit ratio (FDR), which at 52.17 percent, is well above the conventional banks' average ADR of 45.75 percent.

Asset quality has improved …

On the asset quality front, IBIs have performed fairly well. Infection ratio has registered a decline from 4.90 percent in CY15 to 4.13 percent in CY16. A relatively higher growth of 15.65 percent in financing compared with a slight increase of 5.91 percent in NPF lead to a decline in overall NPFR. This is considerably better than that of conventional banks whose infection ratio is 11.03 percent.

However, the provision coverage ratio of IBIs has declined from 95.63 percent in CY15 to 84.67 percent in CY16. Resultantly, the Net infection ratio has increased from 0.22 percent in CY15 to 0.66 percent in CY16. The ratio for conventional bank is recorded at 1.82 percent, though. Similarly, Net NPAs to capital for IBIs has remained at 5.27 percent against the conventional banks' average of 7.43 percent.

Earnings under pressure …

IBIs' earnings have, somewhat, tapered off during CY16 as ROA & ROE-before tax have declined to 1.00 percent and 15.45 percent, respectively, in CY16 as compared to 1.20 percent and 18.67 percent in CY15 - lower than the conventional banks' averages currently at 2.10 percent and 23.85 percent. Net profit income, though a major contributor towards the IBIs' earnings, has declined by 2.07 percent over the year primarily due to a fall in spread, which has declined from 5.19 percent in CY15 to 4.19 percent in CY16. Net non–markup income, on the other hand, has increased by 6.14 percent in CY16 (**Figure 3.2.5**).

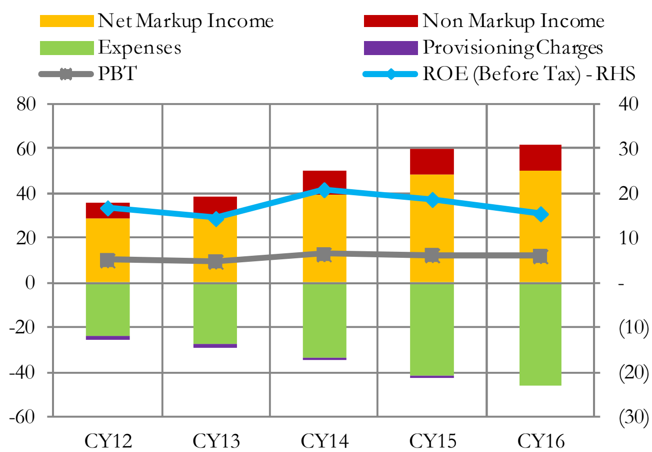
In a scenario where the benchmark rate for conventional banks is declining in the wake of easy monetary policy, the competitive decline in the mark-up income of IBIs is understandable. Moreover, markup income of IBIs have also come under stress due to limited investment avenues (e.g. Ijara Sukuks) as compared to conventional banks which have access to ample interest based Government securities (PIBs and T-bills). Nonetheless, an increase in the non-profit income is encouraging as the Islamic banks are exploring other avenues to shore up their overall earnings.

Figure 3.2.5

IBIs earnings moderated

IBIs' Earnings and Expenses

(amount in PKR billion, ratio in percent)



Source: FSD, SBP

As discussed earlier, Islamic banks are expanding outreach through expansion of their branch network. This coupled with increase in the related administrative and operating expenses, including the personnel expenses and investment in IT infrastructure, have increased the total non-markup expenses which in turn has impacted the profits of IBIs. The high capital expenditures and salary expenses are, however, expected to facilitate future income stream of IBIs.

Capital adequacy above the required level…

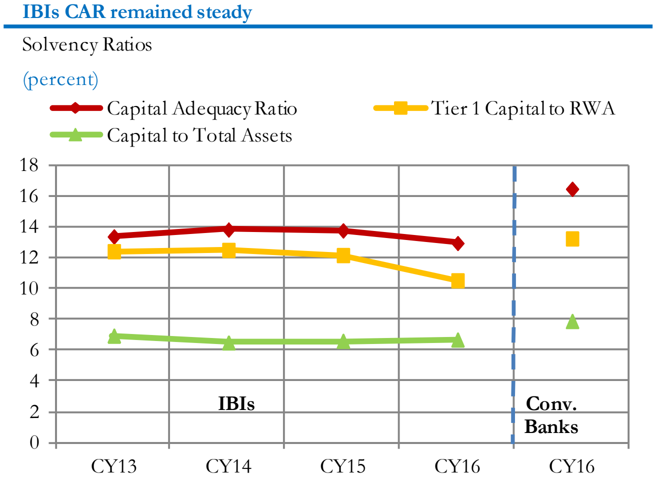
The CAR of IBs has declined from 13.75 percent in CY15 to 12.94 percent in CY16; though it is still above the required level of 10.65 percent (**Figure 3.2.6**). CAR of IBs is, however, below the conventional banking industry's level of 16.45 percent in CY16. The main reason for relatively lower CAR is the significant growth of risk-weighted exposure due to increase in financing by IBs, which in a way has improved the utilization of available capital buffer.

Similarly, the other capital adequacy indicators like Capital to Assets and Total Capital to Total RWA of IBs are also lower than the average of the conventional banks.

Nevertheless, IBs needs to strengthen their capital adequacy position in view of evolving regulatory requirements till 2019[110] and narrowing profitability which limits plough back of retained earnings to the capital. Moreover, current expansionary focus of IBs also demands more capital cushion.

Figure 3.2.6

IBIs CAR remained steady



Capital Adequacy Ratio and Tier 1 Capital to RWA ratio are for Islamic Banks only, while Capital to Total Assets include both Islamic Banks and Islamic Banking Branches.

Source: FSD, SBP

Way forward….

The conducive regulatory environment provided by SBP, the positive economic outlook and the CPEC related projects in energy and infrastructure sectors offer significant opportunities to IBIs. Besides infrastructure financing, IBIs may also exploit the hugely untapped market of agriculture and SME sectors. A key challenge in this regard is product development and product diversification. In addition, conventional banks offering Islamic banking through IBBs need to capitalize on their huge branch network for booking Islamic banking assets as well.

Promotion of Islamic banking requires concerted efforts from all stakeholders. SBP's strategic plan for Islamic banking industry (2014-18) has already set the tone for the essential pre-requisites for promotion of Islamic banking industry.

110 BPRD Circular No. 6 of 2013
http://www.sbp.org.pk/bprd/2013/C6.htm