

3.2 Performance and Risk Analysis of the Islamic Banking Industry

While global banking sector has seen deceleration, Islamic Banking Institutions (IBIs) in Pakistan have shown healthy growth of 17 percent. In the domestic context, the growth in assets of IBIs has outpaced those of the conventional banks, mainly due to surge in financing. IBIs have improved the diversity in Shariah modes of financing, particularly in Profit and loss sharing modes. Most of the increase in financing is funded by strong growth in deposits. Improved asset quality and rise in profitability have enhanced the soundness and stability of IBIs. Liquidity deployment in the short term remains the key challenge faced by the IBIs, while need remains for improving the suit of products for increasing financing to SME and agriculture sector.

The global Islamic Financial Services Industry (IFSI) is decelerating...

On the Global landscape, Islamic Financial Services Industry's (IFSI) assets crossed the landmark of USD 2 trillion and reached USD 2.19 trillion at the end of June, 2018 compared to USD 1.89 trillion at the end of June, 2017.¹⁴⁵ The growth has been recorded in all the three sectors i.e. Islamic Capital Markets, Takaful and Islamic Banking. However, the pace of overall growth in dollar value of IFSIs has slowed down (6.9 percent during Jul, 17-Jun, 18 versus 8.5 percent during Jul,16-Jun,17) mainly because of exchange rate depreciation in various jurisdictions. The IFSI has remained sound and stable, despite emergence of various risks including continued trade tensions, inflation and foreign exchange exposures.

Among the IFSIs, the global Islamic banking assets hold around 70 percent share. However, the growth in the assets of Islamic banks has decelerated to 4.16 percent during CY18 compared to 10.03 percent increase in CY17 (Table 3.2.1).¹⁴⁶

Table 3.2.1: Global Islamic banking statistics

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18
	USD billion				
Total assets	1,281	1,332	1,531	1,684	1,754
Total Sharia compliant financing	809	854	936	1,020	1,052
Total liabilities	1,181	1,239	1,475	1,626	1,748
	Number				
Islamic banks	170	174	181	188	189
Islamic banking windows	85	85	83	83	81
Islamic banks branches	28,787	29,855	29,901	29,713	29,652

Source: PSIFs countrywise data.

In tandem with assets deceleration, growth in Shariah compliant financing has also slowed down to 3.09 percent in CY18 as compared to 8.95 percent in CY17. The asset quality of global Islamic banks, on an aggregate level, has somewhat strengthened

The profitability of the global Islamic banking industry seen marginal decline over the year. The ROA marginally declined to 1.86 percent during CY18 from 1.92 percent in CY17, while ROE has declined by 124 bps to 15.62 percent in CY18.¹⁴⁷ Further, the CAR of Islamic banking industry has remained strong at 12.3 percent, which is well above the international benchmark of 10.5 percent. Similarly, Islamic banking sector of most of the jurisdictions have robust capital positions.

Islamic Financial Services Board (IFSB), 2019. Islamic Financial Services Industry Stability Report 2019. Available at: <https://www.ifsb.org/download.php?id=5231&lang=English&pg=/sec03.php>

¹⁴⁶ Islamic Financial Services Board (2018). Islamic Financial Services Industry Stability Report 2018. [online] Kuala

Lumpur: Islamic Financial Services Board. Available at: <https://www.ifsb.org/download.php?id=4811&lang=English&pg=/sec03.php> [Accessed 27 Feb. 2019].

¹⁴⁷ IFSB Key Exhibits available at: https://www.ifsb.org/psifi_02.php?selfolder=

Despite tightening of domestic macrofinancial conditions, IBIs have outpaced conventional banks in their asset expansion...

The assets of domestic IBIs have continued to grow in CY18, relatively faster than their conventional counterparts, but at a slower pace than the last year owing to growing macroeconomic challenges (**Table 3.2.2**). The assets of IBIs have increased by 17.02 percent during CY18 (22.60 percent in CY17), as opposed to the growth in assets of conventional banks of 5.94 percent. This has mainly been due to significant increase in financing.

Table 3.2.2: Performance of Islamic banking in Pakistan

	IBIs			Conv. Banks		
	CY16	CY17	CY18	CY16	CY17	CY18
	PKR Billion					
Total Assets	1,853	2,272	2,658	13,978	16,070	17,024
Investments (net)	490	534	515	7,019	8,195	7,399
Financing (net)	821	1,207	1,511	4,678	5,306	6,444
Deposits	1,573	1,885	2,203	10,225	11,127	12,051
	Percent Change					
Total Assets	15.09	22.60	17.02	11.53	14.96	5.94
Investments (net)	13.45	9.03	(3.59)	8.84	16.75	(9.71)
Financing (net)	27.21	47.01	25.20	12.17	13.42	21.46
Deposits	14.44	19.81	16.87	13.42	8.82	8.31

Source: SBP

As a result, the share of Shariah compliant banking assets in the total banking assets has increased to 13.51 percent in CY18 compared to 12.39 percent in CY17.

Financing has increased rapidly ...

As opposed to 21.46 percent growth in advances of conventional banks, the IBIs' financing has increased by 25.20 percent during CY18. Resultantly, the share of Shariah compliant financing in total advances has increased to 18.99 percent in CY18 (18.53 percent in CY17 and 9.19 percent in CY14). This expansion has contributed to around 80 percent in the growth of total assets of the IBIs.

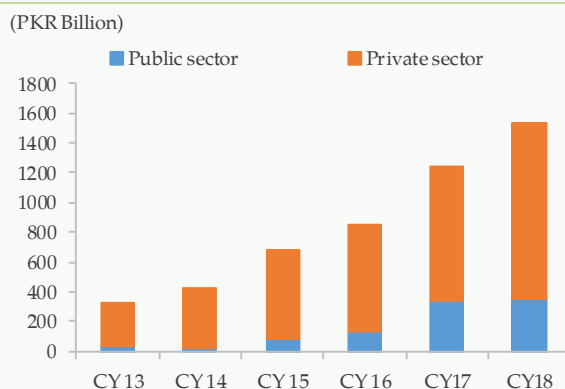
The relatively better financial intermediation by IBIs could be due to higher preference of customers for Shariah-compliant products, availability of low cost funding, and a better credit risk assessment. Besides, lack of Shariah compliant investment opportunities

is encouraging IBIs to focus more on their core financing activities. As a result, there is high growth in financing backed by the reasonable increase in deposits. The financing to deposit ratio of IBIs have increased to 68.58 percent in CY18 from 64.02 percent in CY17.

...for both the private and public sector ...

Private sector financing has maintained healthy growth over the years with another 32.27 percent rise in CY18 in comparison to 24.93 percent in CY17 (**Chart 3.2.1**). In tandem with the private sector, the share of public sector financing has also been increasing mainly because of commodity operations. The major portion i.e. 98.69 percent is outstanding against wheat financing. However, the financing entails no credit risk as the repayment is guaranteed by the government department(s).

Chart 3.2.1: Public and private sector Islamic financing



Source: SBP

... while diversity in financing continues to grow ...

IBIs are extending financing under three broader modes i.e. Trade based, Lease based, and Profit and Loss sharing based. There are various Shariah compliant products within each mode to cater for the diverse credit needs of the individuals and institutional borrowers. Over the years, the profit and loss sharing modes of financing have observed increased share in the overall financing. The share of Musharaka and Diminishing Musharaka has

increased from 43.6 percent in CY14 to 53 percent in CY18.

Within the various modes of financing, Diminishing Musharaka represents 1/3rd of the total financing during CY18 (Table 3.2.3). While the share remains high, the concentration in this particular mode is not alarming as it offers diverse range of financing product backed by tangible assets including machinery, construction of storage facility/ sheds/commercial or residential buildings etc.

Table 3.2.3: Islamic modes of financing

	CY15		CY16		CY17		CY18	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
amount in PKR billion, share in percent								
Murabaha	161.6	23.87	136.7	16.07	162.8	13.16	212.9	13.81
Salam	35.1	5.19	37.1	4.36	34.6	2.80	36.4	2.36
Istisna	56.8	8.39	75.0	8.82	101.0	8.16	140.0	9.08
Musharaka	92.1	13.60	133.4	15.68	272.1	21.99	306.0	19.85
Ijara	43.3	6.40	58.2	6.84	78.8	6.37	95.5	6.19
Car Ijara	27.5	4.06	37.5	4.41	46.6	3.76	61.2	3.97
Plant and machinery Ijara	9.2	1.36	11.1	1.31	13.8	1.12	19.6	1.27
Equipment	0.6	0.08	1.1	0.13	3.1	0.25	2.7	0.18
Others Ijara	6.1	0.90	8.6	1.01	15.4	1.25	12.1	0.78
Diminishing Musharaka	208.7	30.83	293.7	34.53	380.2	30.73	513.1	33.28
Other Islamic modes of finance	79.1	11.69	116.2	13.67	206.8	16.72	237.1	15.38
Mudarabah	0.2	0.03	0.1	0.01	-	-	-	-
Qard/Qard-e-Hasan	0.04	0.01	0.20	0.02	0.68	0.06	0.68	0.04
Total	677.0	100	850.6	100	1,237.0	100	1,541.7	100

Source: SBP

Corporate sector remains major borrower...

In terms of segment-wise financing, the IBIs have served the corporates more than any other segment (88.96 percent of net financing in CY18). This is despite some deceleration in corporate financing (31.02 percent growth in CY18 versus 32.64 percent in CY17) (Table 3.2.4).

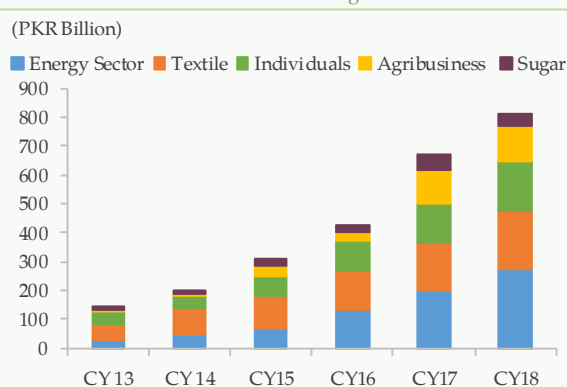
Table 3.2.4: Segment-wise Islamic financing

	IBIs			Conv. Banks		
	CY16	CY17	CY18	CY16	CY17	CY18
PKR Billion						
Corporate Sector:	658.8	873.8	1,144.8	3,397.9	3,955.8	4,885.8
Fixed Investment	339.5	425.5	541.2	1,571.7	1,817.8	2,112.6
Working Capital	260.4	360.5	497.4	1,111.3	1,275.5	1,730.3
Trade Finance	58.8	87.7	106.2	715.0	862.5	1,042.9
SMEs:	29.0	40.6	57.2	375.6	411.8	447.8
Fixed Investment	7.4	12.3	23.1	80.9	86.1	95.3
Working Capital	20.3	26.5	31.5	250.6	284.2	305.4
Trade Finance	1.4	1.9	2.5	44.2	41.5	47.1
Agriculture	6.8	5.6	5.0	287.5	310.6	319.3
Consumer Finance	89.7	122.1	155.5	282.1	326.4	379.9
Commodity Financing	47.4	172.0	161.5	571.9	563.4	702.4
Staff Loans	10.0	11.8	14.6	94.1	103.7	112.4
Others	8.8	11.1	3.0	153.4	120.9	135.6
Total	850.6	1,237.0	1,541.7	5,162.5	5,792.4	6,983.1

Source: SBP

However, sectoral analysis reveals that the financing is well diversified. The largest user of the Islamic financing is the energy sector with the share of 17.70 percent in total financing in CY18 followed by textile (12.97 percent) and individuals¹⁴⁸ (11.42 percent) (Chart 3.2.2). During CY18, the highest growth of 34.84 percent has been registered in energy sector followed by individuals (29.27 percent) and textile (23.91 percent).

Chart 3.2.2: Sector-wise Islamic financing



Source: SBP

Despite marginal slowdown in Islamic corporate financing, the share of the same in total corporate financing has risen to 18.98 percent in CY18 from 18.09 percent in CY17.

¹⁴⁸ Individual includes financing to consumer, sole proprietorships, and any business owned by single individual, irrespective of the size of its operations.

...while share of financing to SMEs and agriculture remains low...

The financing to SMEs has witnessed exponential growth over the last few years. SME financing has increased by 40.64 percent in CY18 (39.96 percent in CY17). The rise in SME financing can be attributed, among others, to indicative financing targets advised by SBP.¹⁴⁹ The outstanding SME Islamic financing has increased from PKR 29 billion in CY16 to PKR 57 billion in CY18. Accordingly, the share of IBIs in overall SME financing has increased to 11.32 percent in CY18 from 7.18 percent in CY16. However, the share of SME financing in total Islamic finance portfolio remain low at 3.71 percent.

Agriculture is the key contributor to the GDP of Pakistan. However, Agri-finance have less than 0.5 percent share in IBIs financing and is lagging behind 5 percent share in conventional banks' lending. Even the share of Islamic agriculture financing in overall agriculture financing has declined to 1.55 percent to CY18 from 1.77 percent a year earlier. While SBP has issued detailed guidelines on Islamic financing for agriculture, IBIs are still to utilize the available regulatory framework for venturing into and enhancing agricultural financing.

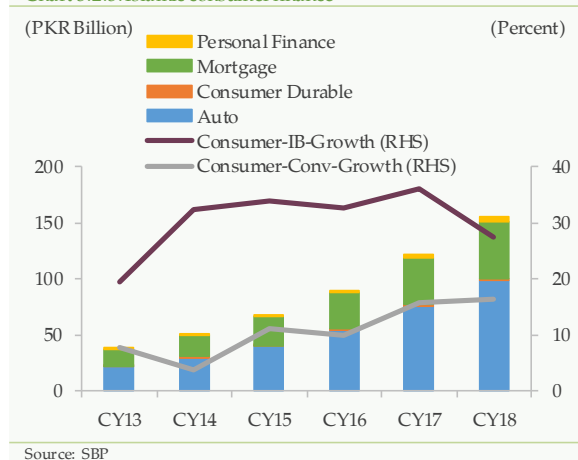
Healthy growth improved the share of Islamic Consumer Finance...

On the other hand, the share of Islamic consumer financing in total financing has risen to 29.05 percent in CY18 from 27.23 percent in CY17. The overall growth in consumer financing has been 19.40 percent in CY18 compared to 20.62 percent in CY17 (Chart 3.2.3). Despite this deceleration, Islamic consumer financing contributes to 38.43 percent in overall growth of consumer financing. Within this particular segment, IBIs encompass 47.15 percent and 54.56

¹⁴⁹As per "Policy for promotion of SME Finance", SBP assigned SME financing targets to banks and DFIs for the first time in 2016 in order to enhance access to credit to this sector. SBP is targeting SME financing to reach 17 percent of total private

percent share in overall auto and house financing, respectively. This growth has mainly resulted from these modes being asset backed (Ijara for Auto finance and Diminishing Musharaka for housing finance) and consumer preference for the Islamic mode of consumer financing over the conventional financing.

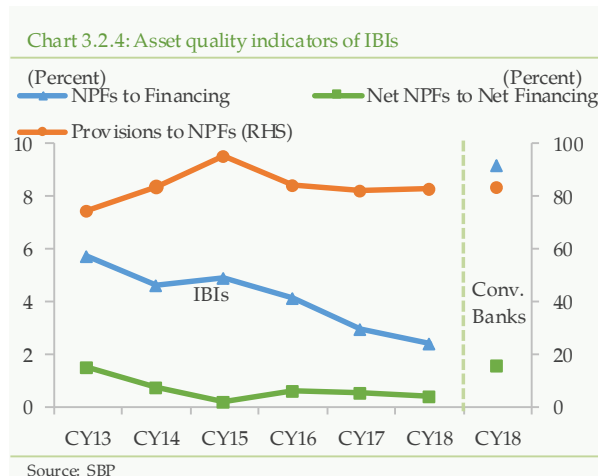
Chart 3.2.3: Islamic consumer finance



The asset quality of IBIs has improved, suggesting lower credit risk...

The asset quality indicators of IBIs remains strong. The Non Performing Financing (NPF) to gross financing ratio has decreased from 2.97 percent in CY17 to 2.41 percent in CY18 (Chart 3.2.4). The provision coverage is at a comfortable level as it has increased to 83.20 percent in CY18 from 82.51 percent a year earlier. The improvement in the asset quality indicators despite the increase in policy rate and macro-economic vulnerabilities indicates, to some extent, better credit quality management at IBIs.

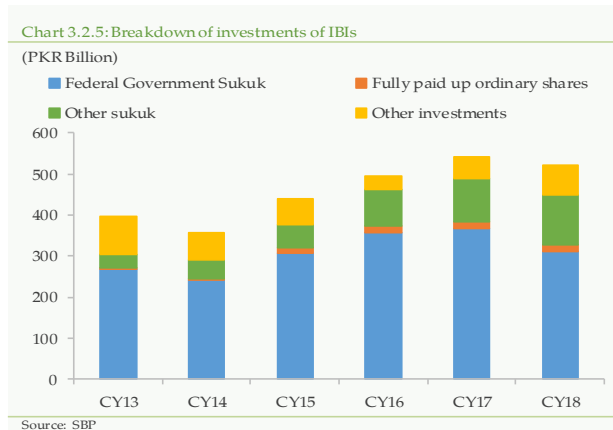
sector credit by the end of 2020. Currently, SME financing is at 6.2 percent of the total private sector credit. Therefore, SME credit is expected to grow significantly in the years ahead.



The dearth of Sharia compliant investment opportunities routes IBIs focus towards financing...

Due to dearth of Sharia compliant investment opportunities, investment portfolio of IBIs has decreased by 3.35 percent in CY18 in contrast to an increase of 9.14 percent in CY17. The share of investments in total assets of IBIs is 19.37 percent, which is 43.46 percent in conventional banks. This has nudged IBIs to expand their intermediation function through higher financing leading to more profitability.

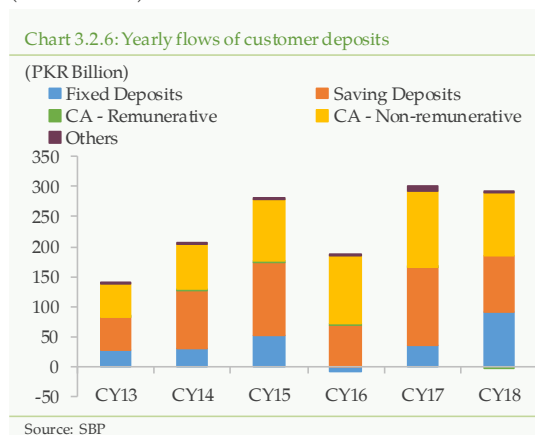
Further, analysis reveals that GoP Sukuk dominates the investment portfolio of IBIs with 59.71 percent share (Chart 3.2.5). Due to net maturity of GoP Sukuk, the share of corporate Sukuk in total



¹⁵⁰ SBP has issued Minimum Saving Rate (MSR) Policy for banks in terms of which are required to remunerate the saving deposits at least at 50bps below the floor of the interest rate

investment portfolio has risen to 23.04 percent in CY18 from 19.58 percent in CY17. *Deposits have provided needed funding for asset expansion...*

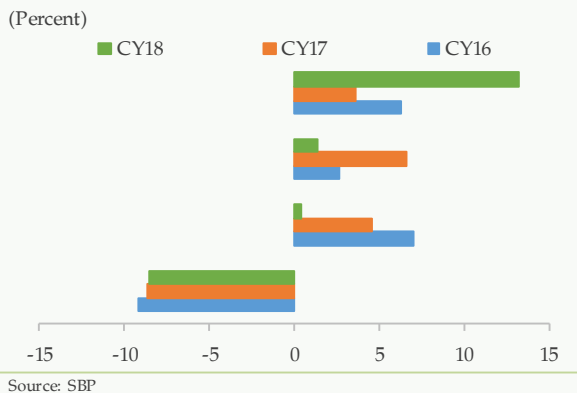
Deposits are the mainstay of funding for the IBIs. Though deposit growth has decelerated to 16.87 percent in CY18 compared to 19.81 percent in CY17, they have funded 82.21 percent growth of total assets during CY18. Both the savings and current deposits, have witnessed deceleration in growth. Fixed deposits, on the other hand, have surged by 24.09 percent in CY18 compared to 10.41 percent in CY17 (Chart 3.2.6).



The growth in fixed deposits is quite substantial as it accounts for 67.44 percent addition in total fixed deposits of all banks. It seems that with growing financing to deposit ratio IBIs have a) increased mobilization of fixed deposit, in an increasing interest rate environment and at a relatively lower cost than the conventional banks¹⁵⁰; and b) opted to mobilizing long-term deposits to improve their maturity profile; IBIs have mostly mobilized deposits with maturity above 3 years. The latter aspects has helped IBIs in improving the overall maturity gap due to improvement in financing flow and compositional change in the deposit profile. (Chart 3.2.7).

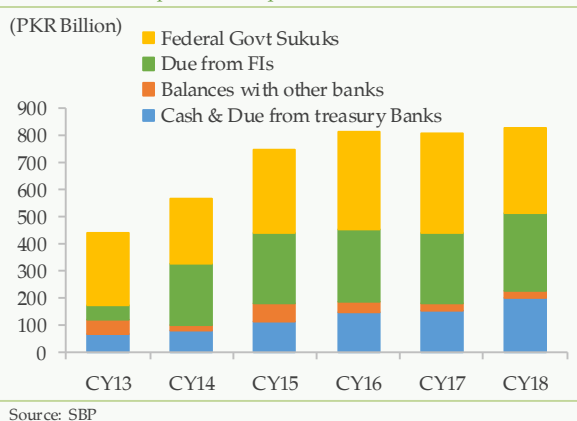
corridor. However, keeping in view the Sharia Laws, SBP exempted IBIs to observe the Minimum Saving Rate on deposits vide BPRD Circular No. 7 of 2008..

Chart 3.2.7: Maturity GAP (assets-liabilities) as percent of total assets



The scarcity of short-term investment instruments for deployment of funds has remained a key issue for IBIs. Due to net maturities of GoP sukuk during CY18, liquid assets have declined by 2.98 percent to PKR 596 billion. As a result, liquid assets to total assets has seen considerable decline to 22.41 percent over a year. Further, IBIs have kept 27.83 percent of their liquid assets in the form of “cash, balances with other banks and lending to financial institutions” compared to 16.59 percent in case of conventional banks (Chart 3.2.8). However, IBIs liquidity remain in a comfortable zone as the Statutory Liquidity Requirement (SLR) for IBIs stands at 14 percent against the requirement of 19 percent for the conventional banks.

Chart 3.2.8: Composition of liquid assets of IBIs



Low borrowings entail limited funding risk...

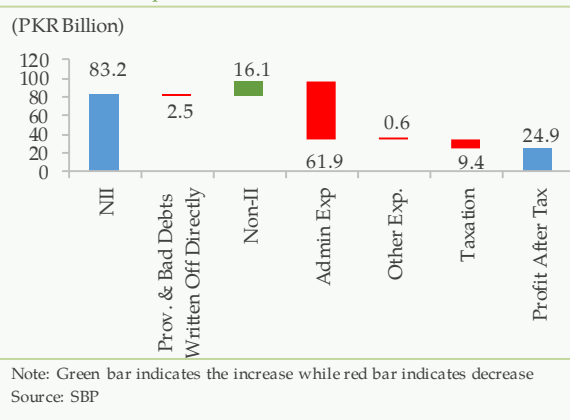
Contrary to conventional banks reliance on borrowings (12.73 percent), IBIs have funded 6.23 percent of their total assets through borrowing on average.¹⁵¹ Lack of Shariah compliant instruments in interbank market also restricts the borrowing of IBIs which may lead to funding risk in short-term. As such, IBIs are more dependent on deposits to finance their assets.

Within the secured borrowing, Islamic export refinance is 44.32 percent of the total borrowings. With the introduction of three different Islamic financing facilities, for Modernization of SMEs, Storage of Agricultural produce, Renewable energy, and financing facility for low cost housing for special segments, it is expected that these secured borrowing facilities from SBP might increase Islamic financing in above focused areas in the future.

IBI's profitability increases ...

The profitability of the IBIs has improved significantly over the year. The profit (after tax) at PKR 24.88 billion has registered an increase of 51.31 percent in during CY18. (Chart 3.2.9). Resultantly, the after-tax Return on Assets (ROA) has improved to 1.02 percent in CY18 from 0.81 percent in CY17.

Chart 3.2.9: Net profit for CY18

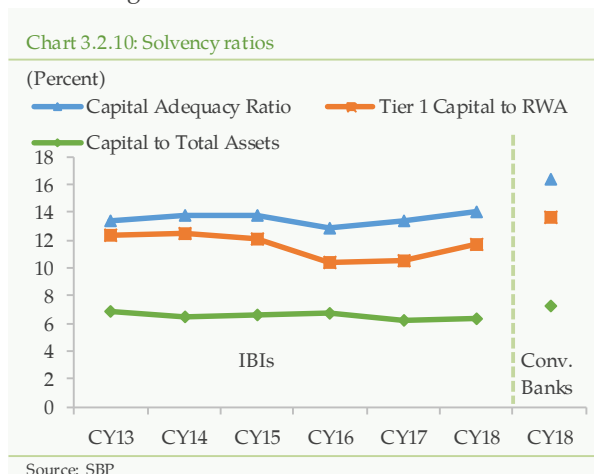


¹⁵¹ IBIs have funded, on an average, 6.23 percent of their assets through borrowings in CY 18 compared to 5.35 percent of their assets in CY17.

Improvement in earning has, mainly, resulted from 29.95 percent increase in net markup income during CY18. Analysis of the components shows that most of this growth in net markup income has been contributed by 44.42 percent rise in markup income from financing activity, while mark-up expense increased by 35 percent.

...which strengthens the solvency profile of IBIs

Driven by high profitability, the solvency of the IBIs has strengthened. CAR has improved to 14.04 percent in CY18 from 13.06 percent in CY17 (Chart 3.2.10), which is well above the regulatory requirement. The improvement can be attributed to increase in the unremitted profit by PKR 17 billion (44.00 percent) in CY18 and dilution of CRWAs due to increase in public sector financing. Despite some improvement, the CAR of IBIs has remained below the conventional banks, primarily, due to high share of financing in total assets.



In addition to the risk confronted by the conventional banks, IBIs are exposed to Shariah non-compliance risk arising from their failure to comply with the Shariah standards. SBP, cognizant of this risk, has put in place a detailed Sharia Governance Framework for IBIs.¹⁵² In addition, it has advised

IBIs to undertake enhanced measures for training and capacity building of their staff.¹⁵³

The Islamic banking industry has continued its impressive growth in CY18. Besides IBIs own efforts, the conducive operating environment provided by SBP has also been an important factor. SBP's efforts in promoting Islamic Banking in Pakistan have been recognized internationally. It has been presented with a global award as the best Central Bank in promoting Islamic finance for the year 2018. The award is conferred by the Islamic Finance News (IFN), an arm of RED money Group, Malaysia.

The IBIs have showed interest in SME financing, which will give impetus to economic growth due to its strong economic interlinkages of SMEs. However, at the same time, it may increase the credit risk of IBIs if credit risk management is compromised. For further product diversification and enhancing contribution in the economic growth, IBIs needs to explore new business opportunities in the low cost housing and enhance financing to agriculture segment.

¹⁵² IBD Circular No. 01 of 2018 available at: <http://www.sbp.org.pk/ibd/2018/C1.htm>

¹⁵³ IBD Circular No. 02 of 2018 available at: <http://www.sbp.org.pk/ibd/2018/C2.htm>