Box 3.1: Islamic Banking

Islamic banking Institutions continued to grow with impressive pace during CY21. Both financing and investments sourced assets expansion, nonetheless, financing contribution was relatively higher as the financing to deposit ratio further increased. Besides strong inflow of deposits, IBIs borrowed significantly to finance assets growth. Due to low profit rate environment, earnings indicators slightly moderated. However with muted credit risk and improvements in asset quality indicators, resilience of the IBIs segment remained robust. Moreover, SBP's continued its efforts to provide enabling regulatory framework for IBIs including the introduction of Shariah Compliant Standing Ceiling Facility and Mudarabah based OMOs-injections.

The Global Islamic Financial Services Industry manifested strong growth …

Despite pandemic related challenges, global Islamic Finance Services Industry (**IFSI**) maintained impressive growth momentum. As per the latest available statistics, the total assets of IFSI grew by 10.7 percent during CY 21 to reach USD 2.7 trillion (USD2.4 trillion in CY19). The Islamic banking and Islamic capital markets underpinned the expansion in assets while Takaful contribution experienced slight contraction.[68]

Domestic Islamic Banking Industry maintained robust growth momentum during CY21…

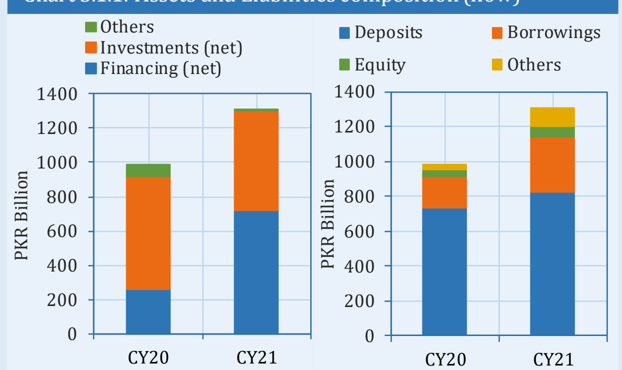
The growth in asset base of the Islamic Banking Institutions (**IBIs**)[69] continued to outpace their conventional counterparts, as it accelerated by 30.6 percent in CY21—slightly up from last year's growth of 30.0 percent (**Table 3.1.1**). Importantly, the pace of expansion was highest since CY12. Unlike last year's trend of investment led growth, financing made the major contribution in assets expansion during CY21 (**Chart 3.1.1**). It is important to note that IBIs are more focused on financing activities as compared to their counterparts conventional banks, and financing constitute 46.6 of IBIs' asset base (as compared to 33.7 of overall banking sector).

Table 3.1.1: Performance of Islamic Banking Institutions

	IBIs			Conventional Banks		
	CY19	CY20	CY21	CY19	CY20	CY21
			PKR Billion			
Total Assets	3,284	4,269	5,577	18,708	20,854	24,482
Investments (net)	597	1,261	1,852	8,343	10,673	12,703
Financing (net)	1,623	1,881	2,597	6,626	6,411	7,523
Deposits	2,652	3,389	4,211	13,301	15,130	17,509
			YoY Percent Change			
Total Assets	23.5	30.0	30.6	9.9	11.5	17.4
Investments (net)	15.9	111.3	46.8	12.8	27.9	19.0
Financing (net)	7.4	15.9	38.1	2.8	-3.3	17.4
Deposits	20.4	27.8	24.2	10.4	13.7	15.7
			Share in Total Assets (Percent)			
Investments (net)	18.2	29.5	33.2	44.6	51.2	51.9
Financing (net)	49.4	44.1	46.6	35.4	30.7	30.7
FDR/ADR (Percent)*	61.2	55.5	61.7	49.8	42.4	43.0

* FDR= Financing to Deposits and ADR=Advances to Deposits
Source: SBP

Chart 3.1.1: Assets and Liabilities composition (flow)



Source: SBP

On funding side, IBIs mobilized PKR 821.7 billion worth of deposits—showing an over the year

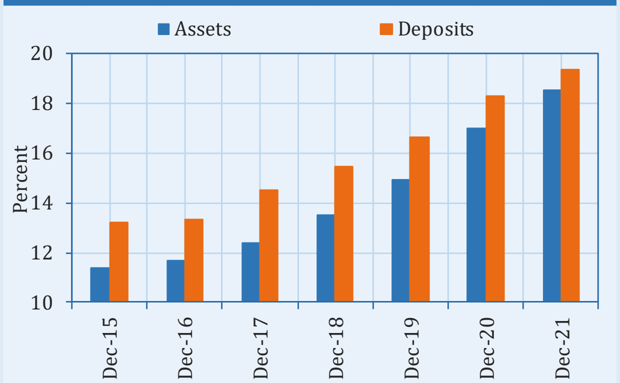
[68] IFSB (2021). *Islamic Finance Services Industry Stability Report.* This latest available report covers the global IFSI performance up till 2020

[69] IBIs include both full-fledged Islamic banks as well as Islamic banking branches of conventional banks

increase of 24.3 percent. Besides, borrowings observed a sizeable rise to meet the increased funding demand to support the growing asset base. It is noteworthy that IBIs' prominence has been increasing over time as IBIs contribute almost one fifth (i.e. 18.6 percent) of the total asset base of banking sector as of end CY21 (11.4 percent share at end Dec-15).

Similarly, share of deposits increased to 19.4 percent from 13.2 percent at end Dec-15 (**Chart 3.1.2**).

Chart 3.1.2: IBIs share in banking industry's ...

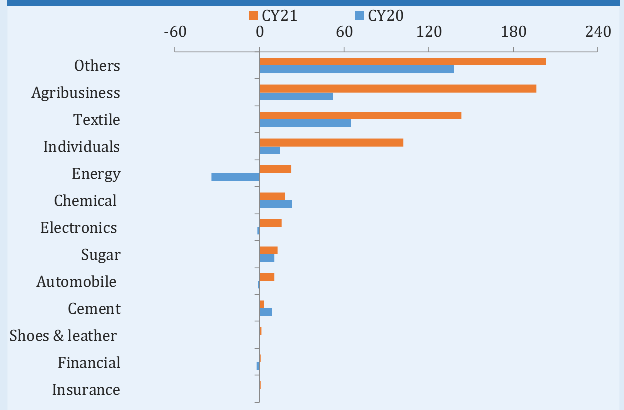


Source: SBP

Financing flows were mainly driven by agribusiness, textiles, and individuals…

The overall gross financing (including public and private) grew by PKR 731 billion in CY21 as compared to PKR 271.6 billion in CY20. Agribusiness, Textiles, and Individuals together availed 60 percent of the total financing flows (**Chart 3.1.3**). Rebound in economic activity, increased input prices, disbursement under TERF, and higher commodity financing for wheat procurement[70] explain robust financing growth.

Chart 3.1.3.: Sector-wise financing flows



Source: SBP

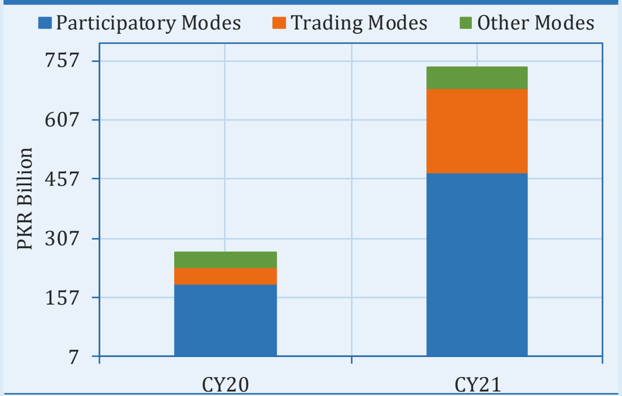
Segment-wise financing analysis indicates that 62 percent of the overall financing was availed by corporates. Working capital and long-term financing mainly drove-up corporate sector financing. Besides, consumer financing increased by PKR 92 billion to PKR 282 PKR billion – mainly driven by PKR 55.1 billion growth in auto-finance. Moreover, mortgage finance posted a heartening increase of PKR 33 billion. It is noteworthy that IBIs have already dominant share in mortgage financing, it was further augmented by SBP's different measures[71] to promote the mortgage finance and construction activities in the economy.

In terms of mode of financing, participatory mode (Musharaka and diminishing Musharaka) continued to dominate the flow of financing. The financing under participatory and trading modes increased by PKR 473 billion and PKR 212 billion, respectively during CY21 (**Chart 3.1.4**).

[70] Minimum support price increased from PKR 1,400 per 40 kg to PKR 1,650 per 40 kg to encourage wheat cultivation.

[71] IH&SMEFD Circular No. 04 of 2021

Chart 3.1.4: Financing flows under different modes



Source: SBP

Encouragingly, financing to deposit ratio observed noticeable improvement…

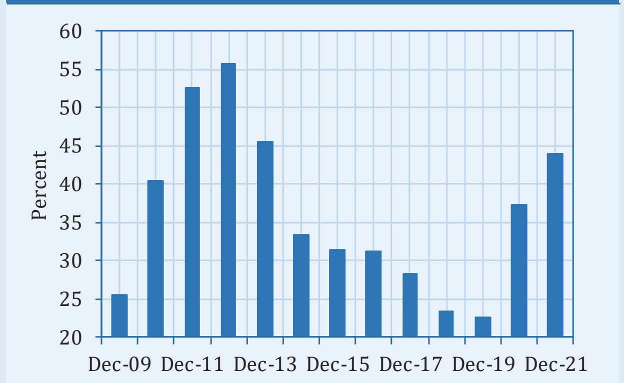
It is noteworthy that IBIs are playing stronger role—as compared to conventional banks—in the intermediation process. The robust rise in financing translated into improved financing to deposit ratio which increased to 61.7 percent by end Dec-21 (55.5 percent at end Dec-20). Accordingly, IBIs have higher financing to deposit ratio as compared to their conventional counterpart's ratio of 46.6 percent at end Dec-21).

With the increased availability of Shariah-compliant instruments, investment portfolio continued to post strong growth, resulting in improvements in the liquidity profile…

IBIs' investments increased by PKR 592 billion (46.8 percent) in CY21 as compared to PKR 664 billion (111.3 percent) in last year. The investments were made in Ijarah Sukuk.[72]

Despite deceleration, Investment to Deposit Ratio (**IDR**) increased to 44.0 percent by end Dec-21 from 37.2 percent a year ago. Moreover, it is noteworthy that IDR—after declining consistently until CY19—rose in recent years (**Chart 3.1.5**). Accordingly, liquid assets to total assets ratio substantially increased to 33.2 percent by end Dec-21 from 20.8 percent at end Dec-20. This illustrates increased availability of Shariah Compliant instruments which in turn facilitate IBIs in managing their liquidity.

Chart 3.1.5: Investments to deposits ratio



Source: SBP

IBIs continued to maintain strong deposits growth…

On funding side, deposits observed a rise of 24.3 percent in CY21 as compared to 27.8 percent growth in previous year. Further analysis reveals that almost entire rise in customers' deposits was contributed by savings and current account (non-remunerative) deposits during CY21 as compared to 86 percent contribution in CY20. This was owing to the contraction in fixed deposits by PKR 14 billion as compared to increase of PKR 82 billion in previous year. Contraction in fixed deposits can be ascribed to lower returns that prevailed during most part of the CY21 due to accommodative monetary policy which led the return-sensitive depositors to explore other investment avenues as well as to IBIs' strategy to focus on mobilizing low cost CASA deposits.

[72] PKR 89 billion were invested in FRR and PKR 647 billion were invested in VRR Sukuks.

The overall strong momentum in deposits—as was also seen in case of conventional banks—was due to a number of factors such as growing remittances and RDA inflows, improved economic activity etc.

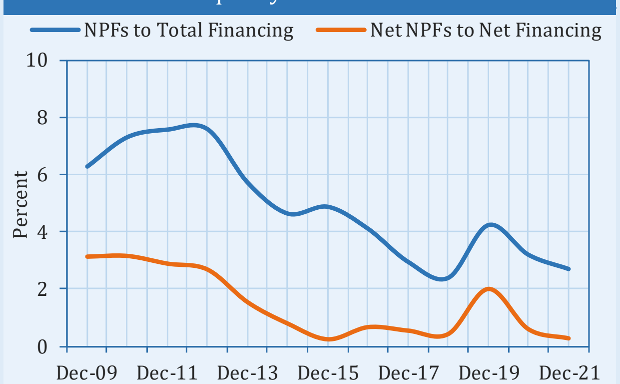
Due to faster growth in asset base, IBIs reliance on borrowings increased over the year…

The IBIs' borrowings (year-end balance) increased by 91.3 percent over CY21 and their contribution in asset base rose to 12 percent by end Dec-21 (8.2 percent in Dec-20). This increase mainly pertained to financing from SBP under different financing schemes.

Credit risk as reflected in asset quality indicators remained in check…

Asset quality of the IBIs further improved in CY21 as Non-Performing Financing (**NPFs**) to total financing ratio declined to 2.7 percent by end Dec-21 from 3.2 percent a year ago. Although, NPFs stock grew by 16.4 percent during CY21, however, sharp rise in financing kept credit risk in check. Moreover, provisioning to NPFs ratio increased to 90.8 percent from 82.4 percent by end Dec-20. Also, Net NPFs to capital ratio came down to 2.1 percent by end Dec-21 from 4.2 percent a year earlier manifesting muted risk to the solvency of IBIs from delinquent portfolio (**Chart 3.2.6**).

Chart 3.1.6: Asset quality indicators



Source: SBP

IBIs posted steady earnings …

After tax earnings of IBIs grew by 4.5 percent in CY21. Although net mark-up income slowed down owing to low profit rate, sharp deceleration in provisioning expenses and marked rise in non-markup income supported IBIs earnings.

Owing to low profit rate environment and strong growth in asset base, after-tax **ROA** and **ROE** moderated to 1.3 percent (1.6 percent in last year) and 21.4 percent (24.5 percent in last year), respectively.

IBIs solvency remained robust…

CAR slightly moderated to 16.0 percent by end Dec-21 from 16.6 percent a year ago. Though the ratio softened yet its level was well above the minimum local and global regulatory requirements of 10.5 percent and 11.5 percent, respectively.

Further analysis reveals that strong growth in TRWA of 18.8 percent relative to 14.3 percent rise in TEC caused moderation in CAR. However, it also represents, utilization of capital to support the financing activities that will in turn augment the banks' earnings and capital position.

Rise in TEC of PKR 24 billion was mainly driven by Tier I capital which increased by PKR 20 billion. Tier I capital to RWA ratio stood at 12.8 percent, indicating that the major part of the regulatory capital comprise better quality instruments which bode well for the solvency against any crisis situation.

More than 75 percent rise in TRWA was contributed by **CRWA** which constitute 80.1 percent of the total risk weighted assets followed by operational risk assets (17.4 percent) and market risk assets (2.5 percent).

SBP's continues to provide enabling regulatory environment for IBIs....

Keeping in the view the increasing size of the industry, nature of its operations, and diversified portfolio of products and services there is a need to have uniform practices across the Islamic banking industry for the management of Shariah Non-Compliance Risk (**SNCR**) and, SBP issued further instructions[73] to broaden IBIs focus on management of SNCR. Particularly, SBP introduced *Shariah Compliant Standing Ceiling Facility* and *Mudarabah-based OMO-Injections* during CY21 to address the liquidity management issues faced by the IBIs (**see Appendix A**).[74] [75]

[73] IBD Circular No.1 of 2021 dated June 14, 2021
[74] DMMD Circular No. 24 of 2021
[75] DMMD Circular No. 25 of 2021