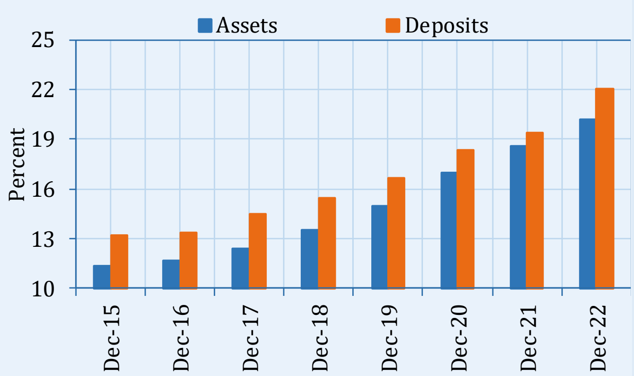
Box 3.1: Islamic Banking

Islamic banking industry continued its impressive pace in CY22. The expansion in the asset base was primarily investment driven as investment avenues widened. Deposit mobilization was robust while reliance on borrowings remained sizable. Asset quality indicators showed healthy trajectory. Also, IBIs' earnings rebounded strongly supporting ROA and ROE. The solvency position further strengthened during CY22 manifesting enhanced loss absorption capacity of IBIs.

Islamic banking industry continued to grow with impressive pace and its market share in the banking sector increased further...

In CY22, Islamic Banking Institutions (**IBIs**)[85] observed 29.6 percent expansion in the asset base — compared to average growth of 24.8 percent in previous five years. The prominence of Islamic banking is steadily growing. This is reflected by a noticeable share of IBIs' in overall banking sector's assets and deposits. In total assets and deposits, IBIs' share stood at 20.2 percent and 22.0 percent, respectively at the end of CY22 (**Chart 3.1.1**).

Chart 3.1.1: IBIs' share in banking industry's assets and deposits



Source: SBP

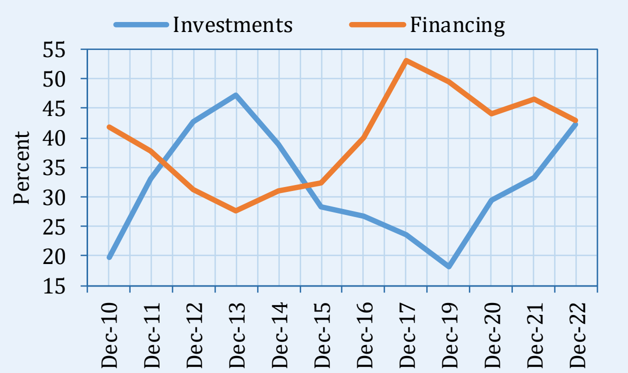
This year growth was primarily driven by investments in domestic sovereign Sukuk, which contributed 72.6 percent of the overall growth in asset base, followed by financing. The role of investments in supporting balance sheet expansion that had been on the rise got further traction during the reviewed year, and their share in asset of IBIs rose to 42.2 percent (from 33.2 percent at the end of CY21) (**Chart 3.1.2).** However, the financing to deposits ratio of IBIs still remained high at 60.3 percent — notably higher than the ADR of 47.6 percent in their conventional counterparts (**Table 3.1.1**).

Table 3.1.1: Performance of Islamic Banking Institutions

	IBIs			Conventional Banks		
	CY20	CY21	CY22	CY20	CY21	CY22
PKR Billion						
Total Assets	4,269	5,577	7,229	20,854	24,482	28,567
Investments (net)	1,261	1,852	3,051	10,673	12,703	15,349
Financing (net)	1,881	2,597	3,113	6,411	7,523	8,705
Deposits	3,389	4,211	5,161	15,130	17,509	18,301
YoY Percent Change						
Total Assets	30.0	30.6	29.6	14.2	17.4	16.7
Investments (net)	111.3	46.8	64.8	33.5	19.0	20.8
Financing (net)	15.9	38.1	19.9	0.5	17.4	15.7
Deposits	27.8	24.2	22.6	16.1	15.7	4.5
Share in Total Assets (Percent)						
Investments (net)	29.5	33.2	42.2	51.2	51.9	53.7
Financing (net)	44.1	46.6	43.1	30.7	30.7	30.5
FDR/ADR (Percent)*	55.5	61.7	60.3	42.4	43.0	47.6

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

Chart 3.1.2: Percent share of investments and financing in total assets

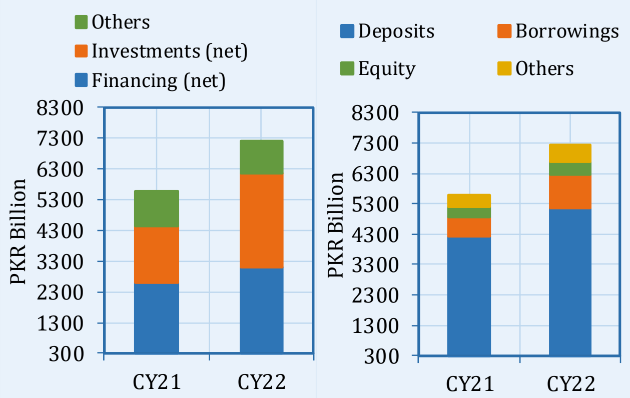


Source: SBP

85 IBIs include both full-fledged Islamic banks as well as Islamic banking branches of conventional banks.

On the funding side, growth in deposits (of PKR 950.1 billion) provided the major support to this year's growth in asset base while reliance on financing from financial institutions also remained high and their share in asset base increased to 15.4 percent from 12.0 percent in last year (**Chart 3.1.3).** Unlike conventional banks, deposits of IBIs witnessed only a slight deceleration during the year under review i.e., growing at the rate of 22.6 percent as compared to 24.2 percent in CY21.

Chart 3.1.3: Assets and liabilities composition of the IBIs (stocks)

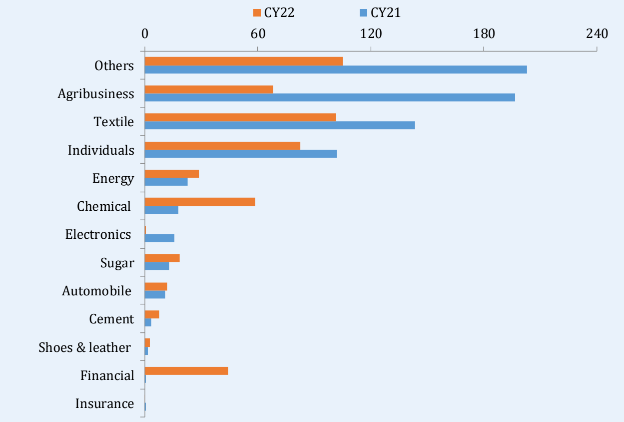


Source: SBP

Financing observed notable deceleration during CY22…

The overall financing (public and private) growth remained subdued (19.9 percent growth in CY22 vs. 37.8 percent in CY21).[86] The slowdown was primarily driven by agribusiness, textiles, and individuals (**Chart 3.1.4**). While buildup of stress in macroeconomic environment and tightening of macro-financial conditions explain lower financing availed by the textile sector and individuals, government's preference to avail relatively higher commodity financing from conventional banks explains pronounced slowdown in IBIs' financing to agribusinesses.

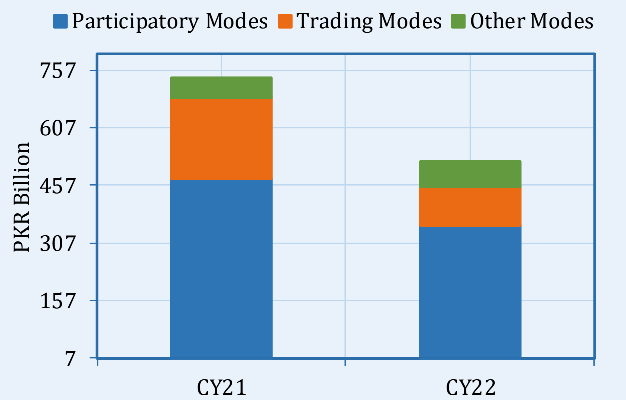
Chart 3.1.4.: Sector-wise overall financing flows



Source: SBP

In terms of modes of financing, participatory mode dominated. During CY22, PKR 354.0 billion and PKR 100.3 billion were availed under participatory and trading modes, respectively (**Chart 3.1.5**).

Chart 3.1.5: Financing flows under different modes



Source: SBP

Greater availability of Shariah compliant instruments further beefed up investments that improved liquidity profile of IBIs…

IBIs' investments increased by PKR 1,199.3 billion (64.8 percent rise) during CY22 as compared to PKR 590.8 billion in CY21. This overall growh in investments was almost entirely (i.e. 99 percent) contributed by growth in the holding of sovereign Sukuk and their share in total investments increased to 82.0 percent. The important development during the reviewed year was

[86] Overall financing flows amounted to PKR 530.1 billion as compared to PKR 730.8 billion in previous year.

provision of additional avenues for investments to the Islamic banking industry, as government added new assets in Government Ijara Sukuk and issued additional Sukuk of PKR 805 billion, showing stepped-up efforts of the policy makers to diversify the government's sources of funding and address liquidity management challenges of IBIs.[87]

Accordingly, liquidity indicators of IBIs posted notable improvement e.g., share of liquid assets in total assets rose to 41.6 percent in CY22 from 33.2 percent in CY21.

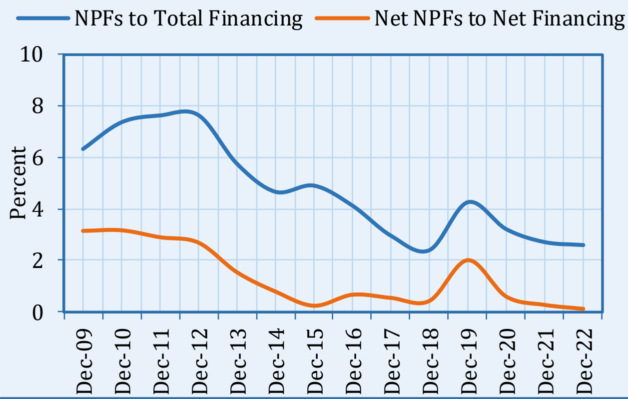
Pace of deposit mobilization remained strong ...

IBIs managed to grow deposits by 22.6 percent (PKR 950.1 billion) during CY22, which was slightly lower than last year's growth of 24.2 percent. The analysis indicates that major growth in deposits was contributed by customers' deposits, wherein fixed and savings deposits explain around 60 percent rise in total increase in customers' deposits. It is noteworthy that this growth in deposits was contrary to the trend of overall banking sector, which observed notable deceleration in customers' desposits . While the rebound in customers' deposits was augmented by the conversion of a bank's entire business to Shairah-compliant mode[88], IBIs' incentive to mobilize deposits remained intact due to their relatively better financing to deposit ratio. Moreover, increase in returns in the wake of tightening monetary policy and higher demand for financing particulalrly from government also augmented the deposits' growth.

Asset quality indicators keep manifesting contained delinquencies...

Along with robust pace of expansion, IBIs have been supporting banking sector's soundness by containing their credit risk. For instance, Non-Performing Financing (**NPF**) to total financing ratio —despite 14.9 percent rise in NPF —further declined to 2.6 percent (2.7 percent in CY21). Also, net NPFs to net financing ratio further improved due to improvement in provisioning coverage of NPFs (**Chart 3.1.6) –** provisioning to NPFs ratio increased to 96.1 percent (90.8 percent in CY21). This was the highest in previous 13 years as the flow of revenues enabled the sector to provide for loan losses.

Chart 3.1.6: Asset quality indicators



Source: SBP

IBIs' earnings increased remarkably...

After tax earnings of IBIs surged by 82.2 percent during the reviewed year (4.5 percent growth in CY21). Profitability was mainly supported by net mark-up income, which rose by 75.9 percent driven by high profit rate environment. As a result of a strong rebound in earnings during the year under review, after tax ROA and ROE increased to 1.7 percent (1.3 percent in CY21) and 30.5 percent (21.4 percent in CY21), respectively.

Soundness of IBIs strengthened during CY22...

CAR improved to 17.8 percent in CY22 from 16.0 percent a year earlier due to stronger increase in capital vis-à-vis RWA. Encouragingly, its level was well above the minimum local requirement and global standard of 10.5 percent and 11.5 percent, respectively. This ratio mainly comprised better-quality Tier-1 capital, with Tier-1 to RWAs ratio of

[87] DMMD Circular Letter No. 01 and 05 of 2022.
[88] Faysal Bank Ltd. has been following a conversion plan to become full-fledged bank. Its process completed by the end of CY22, and w.e.f. January 01, 2023, it became a full-fledged Islamic bank.

15.0 percent, showing marked improvement over the year from 12.8 percent at end CY21.

Further analysis indicates that moderation in TRWA and strong rise in Total Eligible Capital (TEC) helped improve solvency position.

TEC grew by 26.9 percent (or PKR 51 billion) and this entire growth was contributed by Tier I capital which increased by PKR 52 billion while Tier II capital witnessed slight contraction.

The analysis of RWA indicates that deceleration in TRWA (14.2 percent in CY22 vs. 18.8 percent in CY21) was mainly driven by Credit Risk Weighted Assets (CRWA). CRWA and MRWA both decelerated to 9.9 percent (17.7 percent rise in CY21) and 7.4 percent (21.0 percent in CY21), respectively. Nonetheless, in line with growth in gross income, Operational Risk Weighted Assets (ORWA) surged by 34.9 percent in CY22 (23.7 percent in CY21).