9 ISLAMIC FINANCIAL SERVICES

Initially conceived in response to a faith-based logic of conforming to the principles of *Shariah* in all spheres of life,[1] the astounding growth of the Islamic Financial industry also drew on the wealth accumulation in oil-rich countries in the ensuing years, and reflects its potential of being a financially viable and lucrative segment of the global financial system. This view is further reinforced by the interest it has generated in non-muslim countries such as UK, Japan and Singapore where global financial institutions have established *shariah* compliant services in order to capitalize on the potential of the market. Islamic Financial Institutions (IFIs) are now evolving at a rapid pace around the world, where they either co-exist with a parallel system of conventional financial services (Pakistan, Bahrain, United Arab Emirates, Saudi Arabia, Malaysia, Indonesia etc.), or operate in a completely Islamic financial system (Iran, Sudan). Over time, IFIs have been successful in tapping the previously *exluded* market on faith-based considerations, as well as the already *included* segment on preference-based considerations, by giving them the opportunity to choose between two parallel modes of financing and investment.

Growing at 10-15 percent per annum in the last decade, today the Islamic financial industry comprises of a range of financial institutions, including banks, non-bank finance companies, venture capital firms, insurance companies, mutual funds etc., with dedicated regulatory, academic and legal institutions providing the necessary infrastructural support for their development.

The Islamic Financial industry in Pakistan has grown substantially since the launch of SBP's focused strategy to promote a parallel Islamic Banking system in 2003. This performance is commendable for such a short period, given that other countries have achieved a similar growth in their respective Islamic banking industries after several years of existence.

As IFIs develop alongside conventional financial institutions, the industry is faces certain challenges and issues in the form of the rather gradual development of international standards and accounting practices, relative dearth of liquidity management instruments, possibility of regulatory arbitrage in countries with two parallel financial systems where the range of *shariah* compliant financial services are regulated by two separate regulators, competitive pressures from the conventional financial system, divergence in theory and practice of Islamic finance, etc.

Box 9.1: Nature of Contracts in Islamic Financial intermediation

Islam defines certain fundamental economic principles for the functioning of an economy, based on the prohibition of *riba (interest)*, *gharar (contractual uncertainty)* and *maysir (gambling)*, while promoting *zakat.* In practice, these restrictions translate into the following:

1. Risk-sharing : financial transactions should reflect a symmetrical risk/return distribution each participant to the transaction may face;
2. Materiality : a financial transaction needs to be directly / indirectly linked to a real economic transaction;
3. No exploitation : a financial transaction should not lead to the exploitation of any party to the transaction;
4. No financing of sinful activities : such as the production of alcohol, financing a casino, etc.;

Source: Iqbal et al (2004)

[1] Please see **Box 9.1**

Against this backdrop, the discussion of Islamic Financial Services in Pakistan is focused on the development and performance of the industry, and the challenges faced by both the industry players as well as the regulators at various stages of development. The analysis aims to raise awareness of the risks and opportunities that IFIs provide for depositors, investors and borrowers.

While not a threat to financial stability given the total size of the industry at 3.4 percent of total assets of the banking system,[2] potentially systemic issues arising from IFIs bear relevance for analysis, given the growth potential of the industry, their interaction and linkages with systematically important conventional banks, and the possible concentration of risks in a smaller number of institutions.[3]

9.1 Regulatory Infrastructure

Regulatory regimes for Islamic Financial Institutions vary across countries. In Pakistan the industry is regulated by the State Bank of Pakistan (SBP), which supervises the Islamic Banks, and the Securities and Exchange Commission of Pakistan (SECP), which governs the non-bank finance companies, mutual funds, capital markets and takaful companies.

Given the importance of international standards with respect to *Shariah* compliance, several international agencies have emerged in the recent past, such as the Islamic Financial Services Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM) etc, with the mandate to harmonize and strengthen standards.[4]

9.2 Performance Analysis

The Islamic Financial Sector in Pakistan consists of full-fledged Islamic Banks, Islamic branches of conventional banks, modarabas,[5] Islamic mutual funds, and takaful[6] companies. This section also discusses developments relating to *sukuk* issuances in the last few years.

9.2.1 Islamic Banks

The Islamic Banking industry which started with two dedicated institutions, now comprises of 6 full fledged banks offering a range of *shariah* compliant services, with a combined network of 129 branches, and 68 Islamic Banking branches of conventional banks, reflecting an extended degree of outreach of Islamic banking in comparison with previous years. During the year, 2 new Islamic banks with 10 branches each started operations. First Dawood Islamic Bank is the latest entrant in the field (**Table 9.1**).

Table 9.1: Islamic Banking Branches

	Islamic Banks		Conventional Banks		Total No. of Braches
	Banks	Branches	Banks	Branches	
CY05	2	37	9	34	71
CY06	4	93	13	57	150
CY07*	6	129	12[7]	68	197

* As of end-Aug CY07

In terms of strength of players, Meezan Bank is the oldest and biggest player in the market, while Dubai Islamic Bank and Emirates Global denote foreign presence in the sector.

In its efforts to enhance and diversify the coverage of financial institutions in the country, State Bank of Pakistan has introduced the "Improving Access to Financial Services

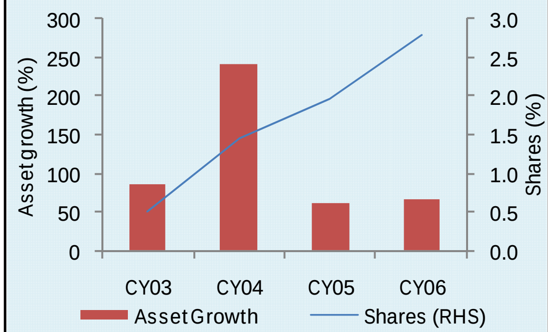
[2] As of end-June CY07.
[3] As discussed in IMF WP/07/175, July 2007.
[4] The role and functions of these institutions have been discussed in 'Financial Sector Assessment 2005', State Bank of Pakistan.
[5] Discussed in detail in Chapter 8 : Performance and Risk Review of the Non-Bank Finance Sector, section 8.3.7 in Part II of this report.
[6] Please see section 10.4 in Chapter 10 : Risk Analysis of the Insurance Sector in Part II of this report.
[7] Due to the mergers of Metropolitan Bank with Habib Bank A. G. Zurich and Prime Bank with ABN Amro Bank.

Programme" (IASP) in the country with the help of the Asian Development Bank (ADB). One of the important clauses[8] of this programme is the provision of Islamic Microfinance Services and products by financial institutions including Islamic banks, commercial banks and micro finance banks. It is expected that this decision would help in enhancing the integration and deepening of the financial sector.

Asset and Liability Structure

The expansion of the Islamic banking industry is complemented by a considerable growth in its assets and liabilities (**Figure 9.1**). Expanding at an annual growth rate of 67 percent, the industry's assets have increased to Rs.119 billion in CY06 (and to Rs. 159 billion by end-June CY07), from Rs.71 billion in CY05. The deposit base has increased from Rs. 50 billion in CY05 to Rs. 84 billion in CY06 (and further to Rs. 108 billion by end-June CY07). With this expansion, the share of the Islamic Banking industry in the overall assets of the financial sector increased to 3.4 percent by end-June CY07. The expansion also gives an indication of the sustainability of these institutions. Commercial viability and sustainability enables banks to take risks in exploring new investment avenues and to develop new products to expand their operations (**Table 9.2**).

Figure 9.1: Performance of Islamic Banking



Source: Islamic Banking Department, SBP

Table 9.2 : Asset and Liability structure of Islamic Banks

million Rupees, share in percent

	CY04		CY05		CY06	
	Amount	**Share**	**Amount**	**Share**	**Amount**	**Share**
			Assets			
Cash and balances with treasury banks	7,899	18	10,284	14	14,846	12
Balances with other banks	4,001	9	9,030	13	16,511	14
Due from financial institutions	0	0	0	0	5,662	5
Investments	2,007	5	1,854	3	7,328	6
Financings- net of provision	27,535	62	45,786	64	65,613	55
Other assets	2,701	6	4,539	6	9,334	8
Total	44,143	100	71,493	100	119,294	100
			Liabilities			
Bills payable	461	1.2	645	1	1,255	1.2
Due to financial institutions	4,482	11.5	4,469	7	6,547	6.4
Borrowings from Head office	2,077	5.3	4,537	7.1	4,296	4.2
Deposits and other accounts	30,185	77.4	49,932	78.4	83,740	81.3
Other liabilities	1,815	4.7	4,100	6.4	7,108	6.9
Total	39,020	100	63,682	100	102,946	100

Source: Islamic Banking Department, SBP

Financing constitutes the major share of the asset portfolio at 55 percent, though the share has decreased in comparison with CY05 when it was 64 percent. While this decline can partly be attributed to monetary tightening, the share of investments in total assets has increased from 2.6 percent to 6.0 percent in CY06. This asset structure indicates a lack of investment avenues for Islamic Banks, which is considered a critical issue even at the international level. In this regard, Islamic REITS (Real Estate Investment Trust) is an appealing development at the global level. The importance of REITS is also being recognized at the national level, and regulations are being developed to make it a formal investment opportunity for all financial institutions, including the IFIs industry. SBP has also constituted a taskforce with the

[8] A-18, 1st Tranch Conditionalities of IASP.

mandate to develop a sovereign *shariah* compliant instrument i.e. Bait-ul-Maal certificates, the proposal of which is currently under consideration.

Although the SLR requirement of Islamic Banks is relatively low[9] as compared to conventional banks, still the lack of a sovereign liquidity management instrument places the Islamic Banks at a relatively disadvantageous position in fulfilling their SLR requirement. Except for the WAPDA Sukuk (**Table 9.3**), there is a dearth of *shariah* complaint SLR eligible instruments. This is substantiated by the fact that despite being tradable in the secondary market, there has been very limited trading activity of the WAPDA Sukuk.

Table 9.3: Investment in WAPDA Sukuk

Bank	Rs. million	Share(percent)
BAL	575	13
MCB	800	19
HBAGZ	125	3
BOK	75	2
Soneri	25	1
Al Habib	25	1
MBL	1,150	27
Albaraka	750	18
DIBPL	485	11
BIPL	250	6
Total	4,260	100

Modes of Financing

Proportion of product wise financing (**Table 9.4**) indicates that Murabaha has the highest share of financing products, followed by Ijarah and Diminishing Musharaka. Murabaha's share has increased from 44 percent in CY05 to 48 percent in CY06. An international perspective of financing trends shows roughly similar patterns in Indonesia and Brunei, though Malaysia is starting to experiment with the more risky modes as well.[10] Preference for various types of financing modes is based on the associated degree of risk and tenor of financing.

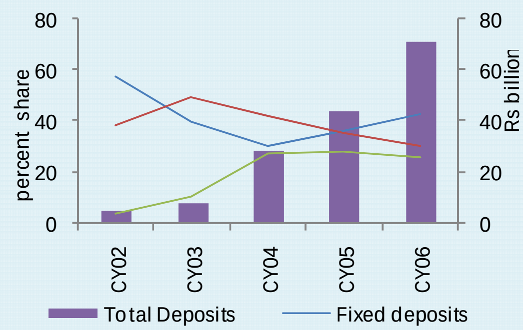
Table 9.4 : Financing Products by Islamic Banks
Share in Percent

Mode of Financing	CY05	CY06
Murabaha	44	48
Ijarah	30	30
Musharaka	0	1
Diminishing Musharaka	13	15
Salam	1	2
Istisna	0	1
Others	12	3

Source: Islamic Banking Department, SBP

Ideally Islamic banking should be based on an equity-based partnership, as signified by the mudaraba and musharakah modes. However, the environment in which IFIs exist has led them to invest heavily in trade finance rather than profit and loss-sharing (PLS) ventures. The reason for the lack of investment in such projects is the high rate of moral hazard and monitoring costs that banks face because of the operating environment and the risk embedded in PLS contracts. Hence IFIs have been aggressively using Murabaha and Ijara, since these modes provide recourse to their investments in the form of collateral secured from the clients..

Figure 9.2: Deposit Structure



Source: Islamic Banking Department, SBP

As in conventional banks, deposits continue to form the largest share of the total liabilities of Islamic banks, at 81 percent in CY06, and end-June CY07. It is interesting to note that in contrast to conventional banks,[11] the share of fixed deposits (**Figure 9.2**) is higher in Islamic

[9] CRR for Islamic Banks is 7 percent of Demand and Time liabilities of tenors less than 1 year, and SLR is 8 percent, as notified in BSD Circular No. 4 and No. 5 dated August 1, 2007.
[10] Information on international financing patterns as consolidated by the Islamic Banking Department, State Bank of Pakistan.
[11] Current accounts have the highest share among all types of deposits for conventional banks.

Banks. The rising share of fixed deposits despite the interest rate differential (rate of return for Islamic banks is lower than conventional banks) is indicative of the growing confidence of the public in the Islamic Banking industry.

Incidentally, all fixed and savings deposits are on the basis of modarabas, and current accounts are based on the principle of *al-wadiah* (trust or safe-keeping)/Qard.

Interestingly, whereas the liabilities side of an IFI offers limited modes of raising funds, the asset side can carry a more diversified portfolio of heterogeneous asset classes representing a wider spectrum of risks and maturity profiles.[12]

Sector-wise allocation of financing

As shown in **Table 9.5,** in a pattern similar to conventional banks, the corporate sector plays a predominant role in the financing share of Islamic Banks, while consumer finance shows a growing share at almost 23 percent in CY06.

Tale 9.5 : Sector wise break up of Financing (Before Provisions)
million Rupees

	CY04		CY05		CY06	
Total Financing	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**
Corporate Sector	16,502.8	61.9	25,930.1	56.2	40,372.8	61.4
SMEs	4,327.0	16.2	6,771.1	14.7	8,541.6	13.0
Agriculture	1,391.7	5.2	88.8	0.2	2.0	0.0
Consumer Financing	2,152.8	8.1	10,012.3	21.7	15,022.4	22.9
Commodity Financing	2,194.2	8.2	3,115.8	6.7	624.9	1.0
Others	111.8	0.4	255.0	0.6	1,178.3	1.8
Total	**26,680.3**	100.0	**46,173.1**	100.0	**65,742.0**	100.0

Financial Performance of Islamic Banks

A review of performance indicators (**Table 9.6**) represents a generally healthier position of Islamic Banks. Capital adequacy ratio has shown an upward trend accompanied by an increase in Risk Weighted Assets[13] (RWA) in CY06, in comparison with CY05. Though return on assets (ROA) depicts a decline, but the high loan to deposit ratio indicates a relatively efficient performance of these institutions. Moreover the NPLs to advances ratios (both gross & net) has declined, representing an improvement in the quality of the assets portfolio.

Table 9.6: Performance indicator of IBs

	CY05	**CY06**
Capital Adequacy ratio	13.7	18.3
NPLs to advances	1.7	1.28
Net NPLs to net advances	0.6	0.36
Provisions to NPLs (billion)	66.4	60.87
Earning asset to total assets	93.7	87.6
ROA (before tax)	2.15	0.87
ROA (After tax)	1.69	0.91
Loans to deposits ratio	68.2	79.1

9.2.2 Islamic Non-Banking Financial Institutions

Under the umbrella of NBFIs, Islamic mutual funds and Modarba companies are currently providing Islamic financial services in the market. Islamic NBFIs depicted a growth of around 19.3 percent which is better than the 13 percent growth rate of FY05 (**Table 9.7**). The other small constituent of Islamic NBFIs i.e. Mutual Funds depicts a rising share in Islamic NBFIs as in the conventional financial industry with a growth rate of 28 percent in Net Asset Value (NAV). A detailed discussion on the Modaraba sector is given in chapter 8.

Table 9.7: Performance of Islamic NBFIs
percent

Growth rates	**FY05**	**FY06**
Modarba companies	19.7	10.9
Mutual Funds	6.5	27.8
Average Growth	13.1	19.3

[12] As discussed in Iqbal (2004).
[13] RWA has increased from Rs.38 million to Rs. 59 million.

9.2.3 Takaful

SECP issued detailed rules for Takaful companies in September 2005 and three Takaful companies i.e. Pak Kuwait Takaful Insurance Company Limited (2003), Takaful Pakistan Limited and Pak-Qatar Family Takaful Company are now operational in the country.

The growth experienced by IFIs has helped spur the development of the Takaful industry. Increasing volume of *shariah* based financial intermediation has created a need for s*hariah* compatible risk mitigation, making takaful operators central in the growth of the industry. At present, around 80 companies are operating around the globe offering life and general insurance services in compliance with *Shariah*. According to IFSB, the estimated average annualized growth of the takaful industry was around 63 percent in 1995-2000. Total insurance premium income of the world is $2.4 trillion whereas in Takaful the total premium income is $2.1 billion.

9.2.4 Sukuks

Islamic bonds or *Sukuks* have captured significant attention from both public and private enterprises for raising funds. Issuance of Sukuk has diversified liquidity management options for Islamic investors. Sukuk issues have been mainly positioned in the Gulf and Malaysian Region. Among others, the Civil Aviation Authority of Dubai floated Sukuk amounting to US $ 1 billion. This was followed by a larger sukuk issue of US $ 2.8 billion offered by the Ports, Customs and Free Zone Corporation of Dubai, a holding company of Dubai Ports World and the Jebel Ali Duty Free Zone.

The government of Pakistan also issued a *Shariah* compliant International Ijara Sukuk of US $ 600 million in January 2005, of a five year tenor, with the Islamabad-Lahore Motorway as the underlying asset. Benefiting from the unique structure of Sukuk instruments, the private sector (**Table 9.8**) in Pakistan has also issued Sukuks to raise capital.

Table 9. 8: Sukuk Issuances in Pakistan

billion Rupees

Name of issuer	Issue
WAPDA Sukuk - I	8
WAPDA Sukuk – II	8
Sitara Chemical Industry	1.7
Wateen Telecom	1.2
Sui Southern Gas Company	1
Karachi Shipyard & Eng. Works	3.5
Pakistan International Airline	2

Source: Islamic Banking Department, SBP

The launch of a benchmark index for Islamic bonds by the Dow Jones Citi Group is also a major development in the sukuk market. The Sukuk index measures the performance of global funds complying with Islamic investment guidelines. The most important objective of this initiative is to provide a benchmark for investors interested in investing in Shariah Compliant fixed income investments. Initiatives like this are expected to develop the secondary market of Islamic bonds, and boost cross-market trading.

9.3 Challenges for growth

This section discusses some of the challenges faced by supervisors, regulators and market-players in the Islamic Financial Industry.

9.3.1 Lack of a sovereign instrument for reserve management

Islamic Banks generally operate in an environment where they have to compete with a parallel system of conventional banks, however they face the shortcoming of managing their liquidity without the availability of the requisite sovereign instruments for this purpose which conventional banks have access to. Recognizing this limitation, SBP requires Islamic Banks to maintain CRR at 7 and 3 percent, and SLR at 8 percent of time and demand liabilities. Furthermore, SBP has allowed Islamic Banks to include their cash in hand and current account balances with National Bank in meeting their SLR requirements.[14]

[14] BSD Circular No. 5 dated August 1, 2007.

9.3.2 Gradual development in standardization of practices

Shariah boards may differ in their interpretations and opinions from institution to institution within the same country, with considerable variations in what is considered acceptable by shariah standards across countries, such that acceptability of a shariah-compliant product in Malaysia may be viewed with some skepticism in other parts of the world. Practices in the South Asian region differ from the East Asian region. These variations exist due to the prevailing schools of thought which give rise to different interpretations on the acceptability of shariah-compliant products.

The pursuit of international consistency would not only ease the task of supervising internationally active institutions, but would also ultimately favor the regulated institutions, as Islamic transactions become better understood. It would also foster integration of IFIs into the international financial community.

9.3.3 Possibility of Regulatory Arbitrage

The disparity arising from the interpretative variation discourages the cross-border use of Islamic products. Instead of regulatory arbitrages, a level playing field should be provided for IFIs. For instance, the FSA (UK) model follows the policy of "no obstacles, not special favors", for Islamic Financial Institutions.

9.3.4 Modalities of regulatory framework with a parallel system of Islamic Finance

In most jurisdictions, IFIs have to comply with regulatory requirements applicable to conventional financial institutions, for instance with respect to MCR requirements, Basle II implementation, Prudential Regulations, etc., despite the distinct nature of their business activities. This is in addition to other regulatory directives specifically tailored for their domain. SBP in the recent past has addressed some of these concerns by issuing separate guidelines for shariah-compliant micro-finance services and (draft) risk management guidelines, etc.

9.3.5 Nature of risks / Risk Profile of IFIs

IFIs are exposed to a unique set of risks, and hence different types of regulations are needed to manage these risks. Terming the development of Islamic finance akin to financial innovation, Iqbal (2004) points out that "financial innovation often brings with it changes in the perception of risk", and rightly argues that the emergence of a parallel system of finance presents challenges similar to financial innovation. There are concerns about this industry's inherent risks and their possible spillover on other segments of the financial sector as it is less well understood than conventional finance.

9.4 Conclusion

The Islamic Financial Services segment is an increasingly important constituent of the financial sector in Pakistan and has grown in size and diversity in just a few years. The participants of the Islamic Banking Industry are all strong players with a sound capital base, compliant with SBP's MCR requirements uniformly applied to both conventional and Islamic Banks, which restricts entry into the sector without the requisite sound financials.

The industry is still in a development phase and it is expected that with time, not only will the practice of Islamic financial intermediation converge with the conceptual foundations on which it is based, both in Pakistan and in other jurisdictions, but will also increase the level of financial depth and penetration by providing financial services to the unbanked segment.