Islamic Banking Bulletin

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Inside

Islamic Banking Department

State Bank of Pakistan

Vision

To Make Islamic Banking the Banking of First Choice for the Providers and Users of Financial Services.

Mission

To Facilitate Development of Islamic Banking Industry in the Country through a) Enabling Legal, Regulatory and Shariah Compliance Framework, b) Leveraging International Best Practices, c) Targeted Research to Better Understand the Market Dynamics, d) Awareness and Promotion Campaign, and e) Industry Capacity Building Initiatives.

Team Leader

Saleem Ullah
saleem.ullah@sbp.org.pk

Team Members

Dr. Mian Farooq Haq
mian.farooq@sbp.org.pk

Muhammad Usman Abbasi
muhammad.usman3@sbp.org.pk

Bushra Shafique
bushra.shafique@sbp.org.pk

Muhammad Amjad
m.amjad@sbp.org.pk

Data Support

Muhammad Amjad
m.amjad@sbp.org.pk

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Islamic Banking Department

State Bank of Pakistan

Executive Director's Speech

Inaugural Speech by Kazi Abdulmuktadir, Executive Director (Banking Supervision Group), State Bank of Pakistan A Lecture by Dr. M. Fahim Khan on "Future of Islamic Banking", arranged by Islamic Learning Resource Centre, SBP, Karachi, May 10, 2012

Honorable Dr. Fahim Khan, distinguished guests from the Islamic banking and finance sector, ladies and gentlemen.

Let me welcome you all to the State Bank of Pakistan for this interesting session on future of Islamic Banking with Dr. Fahim Khan, who according to the write up is a renowned Islamic finance scholar but as per my knowledge a humble Muslim and a good friend. I sincerely thank Dr. Fahim for graciously accepting our invitation to share his views on the Future of Islamic Banking. Dr. Fahim has been closely associated with the development of Islamic Banking post the S.A.B. decision. He was the first member/Secretary of the SBP's Commission on Transformation for Financial System. Former Director, Chief of Islamic Development Bank & currently heads the Riphah Islamic University, Islamabad.

Over the years, Islamic finance industry has experienced significant growth with substantial increase in number of financial institutions offering wide range of services ranging from commercial and investment banking, to takaful, to mutual funds, to capital markets. Given the global expansion and need for dedicated regulations for Islamic finance institutions such as Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Research and Training Institute (IRTI) etc. were established that are playing a significant supporting role for orderly and sound development of the industry.

Pakistan remains one of the forefront countries in promoting Islamic finance services. Efforts in this respect can be traced over the last four decades and presently the Islamic banking sector in Pakistan constitutes about 8 percent of the country's banking system.

State Bank of Pakistan has played a leading role in the effort to promote and develop of the industry. As a result today we have an enabling legal, regulatory and Shariah compliance framework that has facilitated the growth and development of the industry. There is a three tiered comprehensive and credible Shariah Governance framework comprising of Shariah Board at central bank level, Shariah advisor at bank level and a regulatory Shariah compliance inspection practice to ensure adherence of Shariah principles. Furthermore we have in place detailed instructions and guidelines for Shariah compliance and efforts are underway to adapt the internationally recognized accounting, prudential and Shariah standards that have been issued by bodies like AAOIFI and IFSB. To encourage the use of Islamic modes in areas like micro and agri-finance, specific guidelines have been issued. Keeping in view the dire need of industry, SBP has also played an active role in areas like capacity building and raising awareness.

Ladies and gentlemen despite all of this progress, the Islamic finance industry, both globally and locally, is faced with challenges including low awareness about Islamic banking, limited product diversification with predominance of debt/trade based products, capacity constraints of Islamic banks particularly at branches/field level and lack of effective liquidity management solutions.

Further, Islamic banks have negligible presence in SME and agriculture sectors which not only are strategically important for the economy but also promise huge growth opportunities for banks to diversify their products and target markets and sectors. The development of innovative Shariah compliant short term liquidity management instruments has been a challenge for the industry on only in Pakistan but internationally. I have been told that, we are quite close to developing solution in this regard and I am confident that Inshallah within this year and effective and efficient liquidity management solution would be available with us. These challenges without any doubt can only be met by focusing on improving the human resource and research capacity of the industry.

Just to update all of you about some of the initiatives SBP is pursuing are:

1) A comprehensive national survey focusing on collecting data on the knowledge, practices and attitude towards Islamic banking and finance to be used for quantification of demand for Islamic banking in the country.

2) Media campaign on Islamic banking; to be initiated with collaboration of the industry players.

3) Liquidity management framework for Islamic banking institutions.

In this backdrop, I am sure that Dr. Fahim Khan's knowledge will help us in and be beneficial in developing future strategies for the industry.

Thank You.

Sayings of Holy Prophet (P.B.U.H)

…..Nothing of his brother is lawful for a Muslim except what he himself gives willingly. So do not wrong yourselves. O'People! Every Muslim is the brother of every other Muslim, and all the Muslims form one brotherhood. And your slaves; see that you feed them with such food as you eat yourselves, and clothe them with the clothes that you yourselves wear. Take heed not to go astray after me and strike one another's necks. He who (amongst you) has any trust with him, he must return it to its owner.………..

Source: The Last Sermon of The Holy Prophet (P.B.U.H) (Khutbat–ul–Hajjatul Wida, Seerat Ibne Hesham)

Islamic Banking Industry - Progress & Market Shares

Overview: The Islamic banking Industry (IBI) started its tenth year with expansion of 19 branches in first quarter with its asset base reaching to Rs. 644 billion constituting 7.7 percent share of the overall banking industry (see Table 1). IBI has shown a marginal decline in its market share in terms of assets, however, in terms of deposits the share (8.4 percent) has remained the same as of the last quarter; by end of the first quarter deposits of Islamic banking industry were Rs 530 billion. A concerning development is the rising non-performing financing (NPFs) that increased by 8.89 percent during the quarter in contrast to only 1 percent in the last quarter. However despite the surge in NPFs, the industry's earnings remained strong as depicted by ROA and ROE which is higher than that of overall banking industry.

Table 1: Industry Progress and market share

	Islamic Banking Industry Progress (Rs. billion)			Growth (YoY)			Share in Overall Banking Industry		
	Mar-11	Dec-11	Mar-12	Mar-11	Dec-11	Mar-12	Mar-11	Dec-11	Mar-12
Total Assets	497	641	644	33.9%	34.4%	29.5%	6.9%	7.8%	7.7%
Deposits	398	521	530	37.7%	33.6%	33.2%	7.3%	8.4%	8.4%
Net Financing & Investment	374	475	487	63.5%	40.3%	30.3%	6.7%	7.4%	7.4%
Total Islamic Banking Institutions	17	17	17	_	_	_	_	_	_
Total No. of Branches*	759	886	905	_	_	_	_	_	_

Source: Quarterly Unaudited Accounts
*number includes sub-branches

IBI Network Expansion: By the end of first quarter CY12 IBI network comprised of 905 branches in 76 cities indicating addition of 19 new branches (see Table 2); the industry has plans to open total 172 full fledged branches and 26 sub branches in the ongoing year. This slow start of branch expansion at the start of the year is expected and is in accordance with the usual expansion trend of banking industry that paces up towards the end of the year. (For city wise break up of Islamic banking branch network see Annexure III).

Table 2: Province Wise Branches (March 2012)

Province	Cities	Additional No. (Jan 12 Mar-12)	Total No.	Share (percent)
Punjab	31	3	401	44.3
Sindh	13	12	302	33.4
Khyber Pakhtoonkwa	17	4	99	10.9
Baluchistan	9	0	43	4.8
Gilgit Baltistan	1	0	1	0.1
FATA	2	0	2	0.2
Federal Capital	1	0	46	5.1
AJK	2	0	11	1.2
G.Total	**76**	**19**	**905**	**100.0**

Assets: The Islamic banking industry assets base grew marginally to reach Rs. 644 in the quarter ending March 2012. Almost all asset types except "Due from Financial Institutions"[1] have shown negative growth resulting in a significant drop in quarterly growth rate of assets to less than half a percent compared to 12.8 percent in the last quarter (see Table 3). However, this slow down in assets growth during the first quarter is largely in line with the trend in the first quarter when demand is generally low due to the nature of business cycle of many industries.

Component wise analysis of asset portfolio depicts that YoY growth of two main components; financing

[1] Due from Financial institutions constitute only 3 percent of overall assets of IBI

and investments, together dropped from 40.3 percent in quarter ending Dec 2011 to 30.3 percent by end of the quarter ending in March 2012 (see Table 1). Among Financing and Investment, Financing retrenched by 2.8 percent during the quarter compared to 12.8 percent growth in the last quarter while over the same period investment growth rate decelerated to 6.8 percent from 16 percent (see Table 3).

Table 3: Assets of IBI						
	Mar-11		Dec-11		Mar-12	
	Rs. billion	Quarterly GR (percent)	Rs. billion	Quarterly GR (percent)	Rs. billion	Quarterly GR (percent)
Cash & Balances With Treasury Banks	32.7	-9.7%	48.3	31.4%	37.2	-23.0%
Balances With Other Banks	13.7	-49.6%	23.3	1.6%	20.6	-11.7%
Due from Financial Institutions	19.0	-1.2%	13.8	-51.4%	20.5	48.5%
Investments - Net	194.4	23.2%	274.3	16.0%	292.9	6.8%
Financing - Net	179.6	-0.5%	200.2	12.8%	194.5	-2.8%
Operating Fixed Assets	13.3	1.7%	14.7	2.0%	15.0	1.4%
Deferred Tax Assets	2.7	24.3%	3.0	14.0%	3.2	5.4%
Other Assets	41.8	2.2%	63.3	28.6%	59.9	-5.3%
Total Assets	**497.2**	**4.2%**	**641.0**	**12.8%**	**643.8**	**0.4%**

Financing: By end of first quarter CY 12, Financing of IBI amounted to almost Rs. 206 billion with Murabaha having highest share (40.1 percent) followed by Diminishing Musharaka (DM) (35.1 percent) and Ijara (10.7 percent). However, it is interesting to note that the declining share of Murabaha is being mainly compensated by rising share of DM. By end March 2012 the share of DM witnessed a rise from 32 percent to above 35 percent by end Dec 2011 (see Table 4). During the same period share of products like Salam and Istisna have also witnessed a rise however these two products still constitute relatively small share in overall financing portfolio.

Table 4: Financing Mix (percent share)			
	Mar-11	Dec-11	Mar-12
Murabaha	45.4	43.8	40.1
Ijara	12.4	10.4	10.7
Musharaka	3	2.4	0.8
Mudaraba	0.1	0.1	0.1
Diminishing Musharaka (DM)	29.4	32	35.1
Salam	2.5	2.4	3.9
Istisna	4	4.4	5.3
Others	3	4.4	3.9
Total	**100**	**100**	**100**

Table 5: Financing Concentration - percent share				
	Mar-11	Dec-11	Mar-12	Overall Banking Industry
Chemical and Pharmaceuticals	6.8%	7.4%	6.9%	3.8%
Agribusiness	1.6%	4.0%	3.3%	7.7%
Textile	22.6%	20.1%	21.1%	17.8%
Cement	3.6%	3.0%	3.1%	1.9%
Sugar	5.6%	3.3%	5.1%	3.4%
Shoes and leather garments	1.4%	1.6%	1.4%	0.8%
Automobile and transportation equipment	2.3%	1.4%	1.5%	1.4%
Financial	1.4%	1.2%	1.3%	1.9%
Insurance	0.0%	0.0%	0.0%	0.0%
Electronics and electrical appliances	1.5%	1.5%	1.6%	1.4%
Production and transmission of energy	7.2%	10.2%	10.5%	11.8%
Individuals	16.6%	14.9%	15.2%	8.6%
Others	29.3%	31.3%	28.9%	39.4%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

In terms of Industry wise concentration, no significant change is observed during the first quarter of CY12. However, interestingly the share of sugar industry in overall financing of IBI increased from 3.3 percent by Dec 2011 to above 5 percent by March 2012 (see Table 5). This rise is in line with the trend of overall banking industry where the share of Sugar industry in financing increased to 3.4 percent from 2.2 percent during the said period.

Client type Wise financing showed negative growth in all categories during the period under review except Consumer and Staff Financing[2] that depicted a positive growth of 2.5 and 2.2 percent respectively(see Table 6). However, it is pertinent to note that financing of IBI still shows concentration in corporate sector that constitutes almost 74 percent of the financing portfolio followed by Consumer finance (14.6 percent). Low share of SME and agri-financing is depicting potential areas to be exploited particularly SME which is being ignored by the overall banking industry as well.

Table 6 : Client Type Wise Financing Portfolio (Growth Rate & Share) (percent)

	Mar-11		Dec-11		Mar-12	
	Growth rate	Share	Growth rate	Share	Growth rate	Share
Corporate Sector	-4.1	65.2	17.1	73.1	-1.4	73.9
SMEs	-7.3	7.7	10.0	5.2	-5.7	5.1
Agriculture	36.8	0.0	133.0	0.1	-17.0	0.1
Consumer Finance	3.1	20.0	-0.1	13.9	2.5	14.6
Commodity Financing	150.0	4.8	-6.2	5.9	-24.1	4.6
Staff Financing	27.4	1.9	6.7	1.6	2.2	1.7
Others	185.7	0.4	-38.6	0.1	-4.2	0.1
Total	**3.7**	**100.0**	**12.2**	**100.0**	**-2.4**	**100.0**

Investment: Investment base of the industry reached to almost Rs. 293 billion with Federal Government Securities (FGS) having the largest share (66.7 percent). During the period under review investment grew by almost 7 percent mainly driven by FGS that has shown YoY growth of 66 percent (see Table 7) and quarterly growth of 9.1 percent. Fully paid up ordinary shares though have shown quarterly growth of above 40 percent, however it constitutes hardly 1 percent of Investment portfolio of the industry.

Table 7: Investments (Rs. billion)

	Mar-11	Dec-11	Mar-12
Federal government securities	117.5	179	195.4
Fully paid up ordinary shares	1.9	2.3	3.2
TFCs, Debentures, Bonds, & PTCs	29.9	27.5	29.9
Other investments	46.3	66.6	65.5
Investments by type			
Held for Trading	0.1	0	4
Available for Sale	172.6	252.3	268.2
Held to Maturity	15	13.5	13
Surplus /(deficit) on revaluation	0.4	0.9	0.3
Net Investments	194.4	274.3	292.9

Asset Quality: The rising trend of Non-performing Financing (NPF) is a concerning element for asset quality of IBI. During the quarter under review NPFs increased from Rs. 15.9 billion to Rs. 17.3 billion

Table 8: Break up of NPFs (Rs. billion)

				Industry	Share of NPFs (percent)			Industry
	Mar-11	Dec-11	Mar-12	Mar-12	Mar-11	Dec-11	Mar-12	Mar-12
Substandard	2.15	1.94	2.78	56.35	14.37	12.15	16.06	9.26
Doubtful	3.31	2.97	2.39	55.21	22.05	18.61	13.83	9.07
Loss	9.53	11.04	12.12	484.57	63.55	69.24	70.10	79.60

[2] Despite showing positive growth, rate of growth in Staff Financing is still low compared to pervious quarter.

(see Table 8) showing a quarterly growth rate of 8.89 percent. A concerning element is the rise in the category of Loss though the share of Loss in total NPFs of IBI is still lower than that of overall banking industry's average (see Table 8). Moreover, NPF to financing and NPF to capital both showed an upward trend during the quarter though are still lower than those of overall banking industry averages (see Table 9).

Table 9: Non-Performing Financing & Assets (percent)				
	Mar-11	Dec-11	Mar-12	Industry
NPFs to Financing	8.0	7.6	8.4	15.8
Net NPFs to Net Financing	3.4	2.9	3.3	5.6
Provisions to NPFs	58.7	63.0	62.5	68.5
Net NPAs to Total Capital	14.2	10.2	12.0	24.1

Table 10: Break up of Deposits					
				Growth (percent)	
	Mar-11	Dec-11	Mar-12	YoY	QoQ
Deposits	**398.0**	**521.0**	**530.2**	**33.2**	**1.8**
Customers	**375.3**	**483.2**	**495.5**	**32.0**	**2.5**
Fixed Deposits	151.7	185.1	191.4	26.1	3.4
Saving Deposits	133.8	172.4	182.3	36.2	5.7
Current accounts - Remunerative	0.1	1.0	1.0	756.9	-1.9
Current accounts - Non-remunerative	87.4	122.2	118.5	35.5	-3.1
Others	2.3	2.5	2.4	7.9	-1.3
Financial Institutions	**22.7**	**37.8**	**34.7**	**53.1**	**-8.1**
Remunerative Deposits	22.5	37.5	34.0	51.0	-9.2
Non-remunerative Deposits	0.1	0.3	0.7	386.4	110.2
Currency Wise					
Local Currency Deposits	380.7	499.6	508.5	33.5	1.8
Foreign Currency Deposits	17.2	21.4	21.8	26.3	1.9

Liabilities: The deposits and liabilities of the industry grew marginally (0.2 percent) during the quarter as compared to 13.8 percent growth recorded during last quarter. This decline in growth rate was led by significant drop in Deposits[3] growth rate which fell to less than 2 percent from 12 percent in the last quarter. By the end of March 2012, the deposits reached to Rs. 530 billion after an increase of Rs. 9 billion during the quarter, however, no significant change was observed in terms of shares among different categories of deposits (see Table 10); Customer deposits are significantly higher than financial institutions' deposits and share of foreign currency deposits in overall deposits is as low as 4 percent. However among different categories of Customers' deposits saving and Current (non-Remunerative) constitute 67 percent share while for financial institutions' deposits remunerative accounts constitute 98 percent.

Table 11 :Earnings and Profitability Ratios				
	Mar-11	Dec-11	Mar-12	Industry
Net Income to Total Assets(ROA)	1.4%	1.6%	1.6%	1.5%
Return on Equity (ROE)	15.0%	17.3%	17.8%	15.8%
Net Markup Income to Gross Income	80.8%	82.4%	79.7%	73.4%
Non-markup Income to Gross Income	19.2%	17.6%	20.3%	26.6%
Trading & Fx Gains/(Losses) to Gross Income	5.9%	4.6%	5.7%	7.1%
Operating Expense to Gross Income	62.3%	60.4%	62.3%	52.5%
Personnel Expense to Operating Expense	36.9%	34.8%	38.7%	43.8%

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[3] 82 percent of liabilities

Events and Developments

2nd International Conference on Islamic Business (ICIB- 2012) Held at NIBAF (Islamabad), February 28 -29, 2012

Two days 2nd International Conference on Islamic Business (ICIB- 2012) was held at National Institute of Banking & Finance (NIBAF) Islamabad to discuss the practices and prospects of Shariah conforming businesses. The event provided a platform for discussions to researchers, academics, policymakers, corporate leaders, and practitioners of Islamic finance. The conference participants deliberated on challenges of managing the modern day businesses in accordance with Shariah principles.

Lecture on Future of Islamic Banking by Dr. M. Fahim Khan Held at LRC, SBP (Karachi), May 10, 2012

Islamic Banking Department (IBD) arranged a lecture of Dr. M. Fahim Khan on “Future of Islamic Banking”. Dr. Fahim is a prominent economist, writer and researcher in the areas of Islamic economics and finance and is currently Chairman of the Riphah International University (RIU) Islamabad. He also remained the first member-secretary to SBP’s Commission on Transformation of Financial System and also remained associated with Islamic Research and Training Institute (IRTI).

During his lecture to senior management of SBP, CEOs/Presidents of Islamic Banks and Shariah Advisors, Dr. Fahim highlighted the need for realignment of the industry practices with the objectives and principles of Shariah and emphasized the need to make rigorous efforts to remove the misconceptions regarding Islamic banking practices.

Pakistan’s First International Islamic Finance Expo and Conference Held at Expo Centre (Karachi), May 18-19, 2012

Pakistan’s first International Islamic Finance Expo was held on May 18-19, 2012 at Expo Center Karachi. The event was organised by Publicity Channel with the support of State Bank of Pakistan where all the planning and management was undertaken by Ernst and Young Ford Rhodes Sydat Hyder. The event showcased products and services of Islamic banking industry. The exhibition was followed by a conference on “Growth of Islamic Finance Industry with Its Strategic Outlook”.

Sayings of Prophet Muhammad may the peace and blessings of Allah be upon him

Salah Erases Sins

Hadrat Abu Huraira (may Allah be pleased with him) said: The Prophet (may Allah's blessings and peace be upon him) said, "Let anyone tell me; if a stream flows by the house of any person and he baths in it five times a day, whether any dirt will remain on his body." The companions replied that no dirt would remain in such a case. He said, "So is the case with prescribed prayers. Allah forgives men's sins (minor) on their account."

(Bukhari, Muslim)

News

Australia to get first Islamic index

Thomson Reuters and Australia's Crescent Wealth are jointly launching Islamic Australia Index — a research-based index that will offer local and international investors a tool to help invest in accordance with Islamic investment principles in the local market...

http://blogs.wsj.com/dealjournalaustralia/2012/01/25/australia-to-get-first-islamic-index/?mod=google_news_blog

UAE represents 30% of global Islamic banking

ABU DHABI - The Shariah-compliant financial services sector in the country represented 30 per cent of the global Islamic banking industry in 2011, says a report. Abu Dhabi 2011 Report, which has been published by Oxford Business Group...

http://www.khaleejtimes.com/DisplayArticleNew.asp?col=&section=business&xfile=data/business/2012/January/business_January520.xml

IILM plans first Islamic dollar bill sale of up to $1 billion

International Islamic Liquidity Management Corp. plans to sell as much as $1 billion of the first global Shariah-compliant dollar bills by the middle of the year, according to Chairman Zeti Akhtar Aziz. The Kuala Lumpur-based multinational agency postponed the offering last year as it awaited a credit rating, an issue that will be resolved at a meeting in the Middle East this month, Zeti, who is also governor of Malaysia's central bank, told reporters.....

http://www.bloomberg.com/news/2012-03-21/iilm-plans-first-islamic-dollar-bill-sale-of-up-to-1-billion.html

IFSB Council adopts two new guiding principles for the Islamic Financial ...

The Council of the Islamic Financial Services Board (IFSB) has resolved to approve the adoption of two new Guiding Principles in its 20th Meeting in Manama, Bahrain ....

http://ae.zawya.com/story/ZAWYA20120329124747/IFSB-Council-adopts-two-new-guiding-principles-for-the-Islamic-Financial-Services-Industry/

SBP amends Murabaha instructions

KARACHI: The State Bank of Pakistan on Monday amended its earlier instructions with regard to obtaining invoices in the name of banks in Murabaha transactions....

http://www.dawn.com/2012/02/07/sbp-amends-murabaha-instructions.html

'Islamic banking market share set to double in five years'

Yaseen Anwar, governor State Bank of Pakistan (SBP) has expressed the hope that the country's Islamic banking industry is all set to double its market share in the next five years.

http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=95093&Cat=3

Islamic banks urged to explore SME, farm sectors

State Bank Governor Yaseen Anwar has said that the Islamic banking has great opportunity to finance projects in agriculture and small and medium enterprise (SME) sectors which are the avenues missed by conventional financial institutions.

http://www.dawn.com/2012/02/29/islamic-banks-urged-to-explore-sme-farm-sectors.html

Articles/Views

The bailout economy

Source: http://www.greaterkashmir.com/news/2012/Feb/2/the-bailout-economy-29.asp

Interview: Potential of Islamic banking is immense

Source: http://www.dailytimes.com.pk/default.asp?page=2012%5C01%5C08%5Cstory_8-1-2012_pg15_1

Questionable Islamic banking principles

Source: http://www.freemalaysiatoday.com/2012/02/09/questionable-islamic-banking-principles/

Derivatives: Islamic Swaps Liquidity Remains Elusive

Source: http://www.ifre.com/derivatives-islamic-swaps-liquidity-remains-elusive/21009532.article

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Operating Performance: The IBI's earnings remained strong during the quarter with annualized ROA and ROE of 1.6 percent and 17.8 percent respectively, which are higher than that of overall banking industry (see Table 11). It is worth mentioning that mark-up income declined during the period under review while non-mark up income (fee based transactions) increased from 17.6 percent to over 20 percent which may be attributed to significant surge in NPFs during the quarter. The Operating Expense to Gross Income increased to 62 percent during the quarter from 60 percent in the last quarter which is significantly higher than the industry average of 53 percent. This is however attributable to fast pace expansion of the industry and its branch network during the last 3-4 years. As the industry is likely to maintain the growth momentum in the near future, the Operating Expense to Gross Income is also likely to remain higher than the overall banking industry average. The Personnel Expense to Gross Income also increased to 39 percent from 35 percent during the last quarter; it was however lower than the overall banking system average of 44 percent which can be ascribed among others to relatively lower compensation packages in IBIs viz a viz the conventional industry.

Book Review

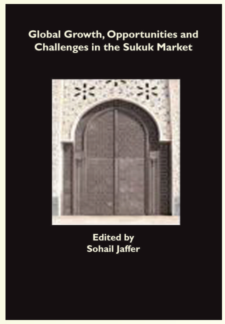
Global Growth, Opportunities and Challenges in the Sukuk Market

Edited by:
Sohail Jaffer

Euromoney Books
(London: Euromoney institutional investor PLC, 2011)

ISBN:
978-1-84374-759-8

237 pages, April 2011



The book "Global Growth, Opportunities and Challenges in the Sukuk Market" has been edited by Sohail Jaffer and has contributions of distinguished scholars from academia and industry. The book provides review of developments in the Sukuk market with particular focus on prevalent legal, Shariah and regulatory issues.

The book is divided into six sections:

Overview of Sukuk and latest trends: The introductory section of the book provides a brief snapshot of international Sukuk market. The section gives an overview of global market providing detailed discussions on domestic trends in various jurisdictions including Malaysia, Indonesia, Turkey, Saudi Arabia and European region. Legal, Shariah and regulatory framework of these regions have also been discussed in this section.

The various roles of Sukuk in the economy: This section begins by providing Sukuk growth experience in Malaysia and presents the country as a global leader in terms of Sukuk issuances. According to the author three core ingredients for success of Malaysia were political will, availability of talent and establishment of required infrastructure. The section also provides an overview of commercial and residential mortgages in France and argues that there is potential opportunity for Islamic finance in the country's real estate market. The section concludes by discussing the role of Sukuk in meeting global challenges as a viable developmental tool.

Sukuk structuring and distribution: The section looks into Sukuk structures commonly used in the global markets along with their key features and illustration of their operations. The Sukuk structures discussed in the section include Ijarah, Musharaka, Mudaraba, Murabaha, Al Salam and Istisna. The section also provides detailed discussion on challenges regarding restructuring of Sukuk issuances with particular focus on Shariah and legal issues in this regard. Legal and tax aspects of cross-border Sukuk structuring have also been reviewed in the section.

Sukuk listing on international stock exchanges: The section provides information on the listing of Sukuk on various stock exchanges of the world including London, Luxemburg and Dubai stock exchanges. Particular focus is given on the regulatory legal and tax regimes prevalent in jurisdictions of these stock exchanges. Moreover, general requirements, process of listing and delisting in these stock exchanges are also discussed in this section.

Rating and accounting of Sukuk: The fifth section focuses on the process of securitization of Sukuk. An overview of the efforts undertaken by various international standard setting bodies like International Organization of Securities Commission (IOSCO), Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Islamic Financial Market (IIFM) and rating agencies regarding securitization and other supervisory requirements are reviewed. This part of the book discusses Sukuk rating methodology with reference to investors' perspective. The section concludes with chapters on Shariah and accounting standards for Sukuk provided by Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and International Financial Reporting Standards (IFRS).

The future of Sukuk: The author provides details of key challenges faced by global Sukuk market believes that given the pipeline of Sukuk issuances announced by various countries of the world, the market is likely to keep buoyant. The book suggests that legal certainty and Shariah standards harmonization is necessary to attract investors from different parts of the world.

In general the author has been able to provide a comprehensive coverage on theoretical and practical issues in the global Sukuk market. The book can thus be termed as a valuable addition in the existing Islamic finance literature and can serve as a useful resource for Islamic finance practitioners.

The Last Sermon of The Holy Prophet (SAWW)

O' People! Listen to my words, for I do not know whether we shall ever meet again and perform Hajj after this year. O' Ye people! Allah says, O' people We created you from one male and one female and made you into tribes and nations, so as to be known to one another. Verily in the sight of Allah, the most honoured amongst you is the one who is most God-fearing. There is no superiority for an Arab over a non-Arab and for a non-Arab over an Arab, nor for the white over the black nor for the black over the white except in God-conciousness.

(Source:, Khutbat-ul-Hajjatul Wida, Seerat Ibne Hesham)

Country Model: United Arab Emirates (UAE)

United Arab Emirates (UAE) is considered a financial and business hub of Middle East as it connects region's markets with rest of the world. Financial centers based in UAE like Dubai International Financial Centre (DIFC) and Abu Dhabi's Sowwah Square have attracted leading financial firms from both USA and European countries. In this backdrop, banking services in UAE have witnessed rapid growth over the years with both local and foreign banks operating in the country.

Islamic financial services started in UAE with the establishment of Dubai Islamic Bank, the world's first formal Islamic bank, in 1975. Since then Islamic banking in the country has shown considerable growth and in terms of provision of services UAE is generally considered as on of the leaders amongst the Gulf Corporation Council (GCC) countries[4]. In terms of market share, Islamic banking constitutes 17 percent share in overall banking industry's assets in UAE[5]. According to a report by Abu Dhabi Islamic Bank, UAE Islamic financial services sector represented 30 percent of global Islamic banking industry in 2011[6]. A wide range of financial products based on Islamic financing modes such as Murabaha, Ijara, Mudaraba and Musharaka are being offered by Islamic banks in UAE.

Islamic banking model in UAE:

Since its establishment in 1975, Dubai Islamic bank remained the only bank providing Islamic banking services in UAE until Abu Dhabi Islamic bank was incorporated in 1998. However, since the beginning of current millennium, few more Islamic banks have started operations in the country either through incorporation of new banks or through conversion of conventional banks to Islamic banks.

Apart from full fledged Islamic banks, conventional banks are also providing Islamic retail, corporate and investment banking services through Islamic banking windows. In addition, Takaful companies and Islamic finance companies apart from national bonds company and conventional finance companies are also operative in the country for provision of Islamic financial services.

The Central bank of UAE acts as the regulatory authority for the banking industry. Given significant growth of Islamic finance a separate law (Federal Law No. 6 of 1985) is operative in the country that deals with Islamic Banks and financial institutions.

Shariah regulatory framework:

The Shariah regulatory framework currently operative in UAE is in accordance with the Federal Law No. 6 of 1985. According to article 5 of Federal Law No. 6, establishment of Higher Shariah Authority is mandated in order to supervise Islamic banks, financial institutions and investment companies to ensure the legitimacy of their operations in accordance with Shariah. The Article further accords the Higher Shariah Authority the final authority in Shariah related matters of Islamic banking and finance. Moreover Article 6 of Federal Law No. 6 also requires formation of Shariah supervision authorities at Islamic financial institutions level after obtaining prior approval from Higher Shariah Authority.

It is important to note that Shariah Coordination Committee was established in 2009 to help in

[4] GCC countries include Saudi Arabia, Kuwait, Bahrain, Qatar, United Arab Emirates and Oman.
[5] Source: World Islamic Banking Competitive Report 2010.
[6] Abu Dhabi 2011 Report, published by Abu Dhabi Islamic Bank (ABIB) in conjunction with Oxford business Group.

standardizing Islamic banking and finance practices in UAE. Moreover, consideration is being given for introduction of a new law for establishing a higher Shariah Council similar to countries like Indonesia and Malaysia.

Liquidity management framework:

As part of its efforts to develop a money market, the central bank of UAE has recently introduced an Islamic certificate of deposit based on the Murabaha concept of financing to provide a source of liquidity to banks. The certificate has been created by the coordination of the central bank of UAE and the Shariah coordination committee.

UAE has also remained active in the Sukuk market and according to International Islamic Financing Market (IIFM) Sukuk report, as of December 2010, UAE had issued Sukuk worth US$ 25,050 million in the international and US$ 7,151 million in the domestic market. In particular prior to 2009 UAE Sukuk market remained very active and witnessed some innovative Sukuk structures including Dubai's Civil Aviation Authority Sukuk, the world's first International Quasi-Sovereign Sukuk, Dubai Ports Authority Sukuk; largest international Musharaka based Sukuk and the Nakheel group Sukuk, largest international corporate Sukuk. However, defaults in 2009, in particular Nakheel group Sukuk default, resulted in slowing down the UAE Sukuk market. The period also witnessed UAE banks going to foreign markets like Malaysia to issue Sukuk. Encouragingly 2011 witnessed some revival in UAE Sukuk market as First Gulf Bank Sukuk issuance witnessed six times oversubscription indicating restoration of investor's interest and confidence in the market.

Sources:

- World Islamic Banking Competitive Report 2010
- International Islamic Financial Market (IIFM) Sukuk Report, 2nd edition, May 2011.
- Islamic Capital Markets: Products and Strategies, Wiley Finance, March 2011.
- Global Islamic Finance Report 2011
- Global Islamic Finance Report 2012
- Central Bank of UAE website.

Behold! Worship your Lord; offer prayers five times a day; observe fast in the month of Ramadan; pay readily the Zakat (poor due) on your property; and perform pilgrimage to the House of God and obey your rulers and you will be admitted to the Paradise of your Lord.
Let him that is present, convey it unto him who is absent, for many people to whom the message is conveyed may be more mindful of it than the audience.
And if you were asked about me,
what would you say?"
They answered, "We bear witness that you have conveyed the trust (of religion) and discharged your ministry of Prophet hood and looked to our welfare."

Islamic Financing
Mode in Focus: Salam

Salam is sale of a good/asset at an agreed price to be delivered at a pre-determined future date with full advance payment at the spot. This is similar to a conventional forward contract, however, in a Salam sale, the buyer pays the entire amount in full at the time the contract is initiated.In modern Islamic banking Salam contract is generally used for agriculture financing however it is also used to finance the working capital needs. In Pakistan around 4 percent of overall Islamic banking financing is Salam based.

Conditions of Salam:
Salam is a unique contract in Islamic finance as it is exception of two general rules i.e. existence of asset and prohibition of forward sale. Due to these general rules, Shariah scholars have defined some conditions that are necessary for the contract to be permissible in terms of Shariah principles. These conditions include

1. The buyer must pay the price in full to the seller at the time of sale.
2. Salam can be affected only in those commodities whose quality and quantity can be specified exactly.
3. Salam cannot be affected on a product of a particular field, farm or factory.
4. The quality of the commodity should be fully specified leaving no ambiguity in order to avoid dispute.
5. The quantity of the commodity must also be agreed upon at the time of contract.
6. The date of delivery must be specified in the contract.
7. Salam cannot be affected for items/goods which must be delivered at spot.
8. Delivery in installments is allowed, if agreed by all parties. Early delivery is allowed if all parties agree and no party is at disadvantage position.
9. The contract of Salam, once affected, cannot be cancelled unilaterally.
10. Before delivery of the asset, the risks on the asset lies with the seller and upon delivery, the risks are transferred to the buyer.
11. Upon delivery of the asset, the buyer is obligated to take possession of the asset if the asset delivered is according to agreed specifications.
12. The buyer can enter into a similar contract with a third party in a parallel Salam. This parallel contract is independent from the first Salam contract.
13. Salam must be concluded with actual physical delivery.

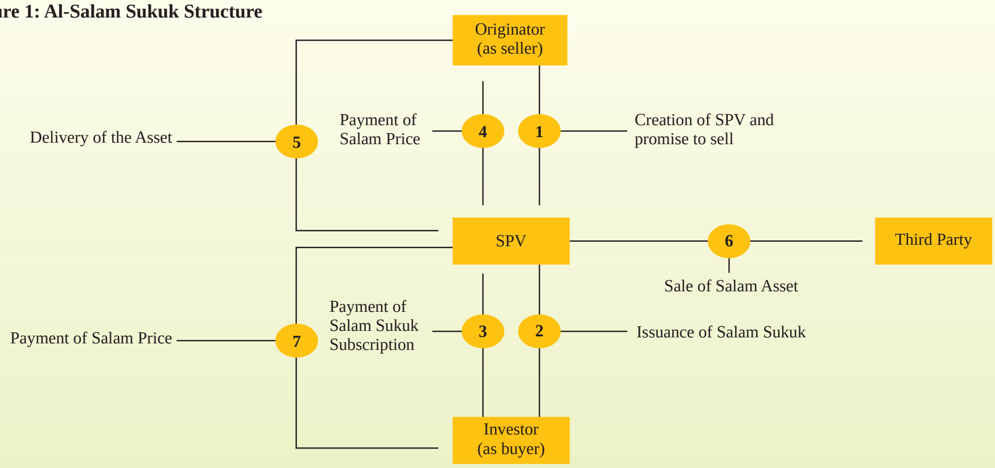
Salam Sukuk:
Salam is also used as the underlying mode in various Sukuk issuances generally for managing liquidity and for meeting short term liquidity requirements. Like any Salam contract Salam Sukuk also needs to fulfill certain conditions in order for it to be Shariah compliant. These include immediate payment at the time of entering the contract and no ambiguity in the contract in terms of asset quality and quantity, expected delivery date etc.

The process of a simple Salam Sukuk structure involves a seller, investors, and an SPV; steps involved in the process are presented in Figure below.

1) The seller creates an SPV and undertakes to deliver the assets to the SPV on the specified future date.
2) The SPV issues Sukuk to investors.

3) Investors pay Sukuk subscription.
4) The SPV passes on Sukuk proceeds to the seller.
5) At the delivery date, the seller delivers the asset to SPV.
6) The SPV sells the asset or appoints the seller as an agent to sell the asset.
7) The SPV pays investors the sale proceeds.

Figure 1: Al-Salam Sukuk Structure



Limitations of Salam:

In modern day banking Salam contract can sometimes be cumbersome for banks as they receive certain commodities from their clients and not money and banks are not conversant with selling these commodities in the market. They cannot sell those commodities before they are actually delivered to them, because it is prohibited in Shariah. However, two solutions to this problem are as follows:

1. After purchasing a commodity the bank may sell it through a parallel contract of Salam for the same date of delivery. OR

2. The bank can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance.

In case of Sukuk, it is pertinent to note that Salam Sukuk cannot be traded in secondary market as it involves debt against advanced payments. Hence this Sukuk is not very popular amongst various Sukuk structures in practice. Another reason for limited availability of Salam Sukuk is due to its uncertainty in providing the assets involved in transactions on time and according to the specification agreed upon in the contract.

Sources:

1. Muhammad Taqi Usmani (2000), “An Introduction to Islamic Finance,” Idaratuk Ma’arif Karachi.

2. Sohail Jaffer (2011), “Global Growth Opportunities and Challenges in the Sukuk Market,” Euromoney books

3. Global Islamic Finance Report 2011, BMB Islamic.

4. The Chancellor Guide to the Legal and Shariah Aspects of Islamic Finance, BMB Islamic (2009).

Islamic Banking Branch Network

(As of March 31, 2012)

Annexure: I

Type	Name of Bank	No of Branches*
Islamic Banks	AlBaraka Bank (Pakistan) Limited	87
	BankIslami Pakistan Limited	70
	Burj Bank Limited	42
	Dubai Islamic Bank Pakistan Ltd	78
	Meezan Bank Ltd	283
		560
Islamic Branches of Conventional Banks	Askari Bank Limited	29
	Bank Al Habib Ltd	11
	Bank Alfalah Ltd	85
	Faysal Bank Limited	46
	Habib Bank Ltd	25
	Habib Metropolitan Bank	4
	MCB Bank Ltd	22
	National Bank of Pakistan	8
	Soneri Bank Ltd	7
	Standard Chartered Bank	15
	The Bank of Khyber	30
	United Bank Ltd	14
	Sub Total	296
Sub Branches	AlBaraka Bank (Pakistan) Limited	2
	Askari Bank Limited	2
	BankIslami Pakistan Limited	32
	Burj Bank Limited	8
	MCB Bank Ltd	2
	The Bank of Khyber	3
	Sub Total	49
	Grand Total	905

* Source: Banking Policy & Regulations Department, State Bank of Pakistan.

Province wise Break-up of Islamic Banking Branch Network

(As of March 31, 2012)

Annexure: II

Type	Bank Name	Azad Kashmir	Balochistan	FATA	Federal Capital	Khyber Pakht-unkhwa	Gilgit-Baltistan	Punjab	Sindh	Grand Total
Islamic Banks	AlBaraka Bank (Pakistan) Limited	1	3	-	4	9	-	42	28	87
	BankIslami Pakistan Limited	1	8	-	2	5	1	30	23	70
	Burj Bank Limited	-	1	-	2	2	-	17	20	42
	Dubai Islamic Bank Pakistan Limited	1	5	-	4	3	-	36	29	78
	Meezan Bank Limited	4	8	-	13	26	-	133	99	283
	IB. Total	7	25	-	25	45	1	258	199	560
Islamic Branches of Conventional Banks	Askari Bank Limited	-	2	-	1	5	-	14	7	29
	Bank AL Habib Limited	-	1	-	-	1	-	3	6	11
	Bank Alfalah Limited	-	3	-	6	4	-	52	20	85
	Faysal Bank Limited	-	2	-	1	12	-	20	11	46
	Habib Bank Limited	2	1	-	2	2	-	10	8	25
	Habib Metropolitan Bank Limited	-	-	-	-	0	-	1	3	4
	MCB Bank Limited	-	1	-	2	1	-	11	7	22
	National Bank of Pakistan	1	-	-	0	1	-	4	2	8
	Soneri Bank Limited	-	1	-	2	1	-	1	2	7
	Standard Chartered Bank(Pakistan)	-	1	-	1	3	-	4	6	15
	The Bank of Khyber	-	2	2	-	19	-	4	3	30
	United Bank Limited	-	1	0	1	2	-	5	5	14
	SAIBBs Total	3	15	2	16	51	0	129	80	296
Sub Branches	AlBaraka Bank (Pakistan) Limited	-	-	-	1	-	-	-	1	2
	Askari Bank Limited	-	-	-	1	-	-	-	1	2
	BankIslami Pakistan Limited	1	3	-	3	2	-	9	14	32
	Burj Bank Limited	-	-	-	-	-	-	3	5	8
	MCB Ban Limited	-	-	-	-	-	-	1	1	2
	The Bank of Khyber	-	-	-	-	1	-	1	1	3
	Sub Branches Total	1	3	0	5	3	0	14	23	49
	Grand Total	11	43	2	46	99	1	401	302	905

City wise Break-up of Islamic Banking Branch Network

(As of Marchi, 31, 2012)

Annexure: III

S.No.	Province	Cities	No. of Br.
1	Sindh	Badin	1
2		Dadu	2
3		Hyderabad	22
4		Jacobabad	1
5		Karachi City	248
6		Larkana	1
7		Matiari	1
8		Mirpur Khas	3
9		Naushero Feroze	1
10		Nawabshah	5
11		Sanghar	5
12		Sukkur	9
13		Tando Allahyar	2
14		Tando Mohammad Khan	1
	Sindh Total		302
15	Punjab	Attock	6
16		Bahawalnagar	5
17		Bahawalpur	4
18		Chakwal	3
19		Dera Ghazi Khan	3
20		Faisalabad	37
21		Gujranwala	14
22		Gujrat	16
23		Hafizabad	2
24		Jhang	3
25		Jhelum	6
26		Kasur	3
27		Khanewal	7
28		Khushab	5
29		Lahore City	149
30		Lodhran	1
31		Mandi Bahauddin	1
32		Mianwali	2
33		Multan	28
34		Muzaffargarh	3
35		Okara	3
36		Pakpattan	2
37		Rahim Yar Khan	10
38		Rawalpindi	44
39		Sahiwal	4
40		Sargodha	12
41		Sheikhupura	5
42		Sialkot	15
43		Toba Tek Singh	3
44		Vehari	5
	Punjab Total		401

S.No.	Province	Cities	No. of Br.
45	Khyber Pakhtunkhwa	Abottabad	11
46		Banu	3
47		Charsadda	3
48		Chitral	1
49		Dera Ismail Khan	5
50		Hangu	2
51		Haripur	4
52		Kohat	3
53		Malakand	1
54		Mansehra	7
55		Mardan	6
55		Nowshera	4
57		Peshawar	40
58		Swabi	3
59		Swat	2
60		Tank	1
61		Upper Dir	3
	KP Total		99
62	Gilgit-Baltistan	Gilgit	1
	Gilgit-Baltistan Total		1
63	FATA	Khyber Agency	1
64		Orakzai Agency	1
	FATA Total		2
65	Federal Capital	Islamabad	46
	Federal Capital Total		46
66	Balochistan	Chagi	1
67		Gawadar	1
68		Kila Abdullah	2
69		Killa Saifullah	3
70		Lasbela	1
71		Loralai	4
72		Pishin	1
73		Quetta	29
74		Zhob	1
		Balochistan Total	43
75	Azad Kashmir	Mirpur	8
76		Muzaffarabad	3
	Azad Kashmir Total		11
	Grand Total		905

Contact Details of Islamic Banking Department Officials

Sr. No.	Name	Designation	Email Address
1	Saleem Ullah	Director	saleemullah@sbp.org.pk
2	Muhammad Yousaf	P.A to Director	muhammd.yousuf@sbp.org.pk
3	Zulfikar Khokhar	Additional Director	zulfikar.khokhar@sbp.org.pk
4	Nighat Tanveer	Senior Joint Director	nighat.tanveer@sbp.org.pk
5	Dr. Mian Farooq Haq	Senior Joint Director	mian.farooq@sbp.org.pk
6	Munir Ahmed	Joint Director	munir.ahmed@sbp.org.pk
7	Ghulam Shabbir	Joint Director	shabbir@sbp.org.pk
8	Aslam Navaid	Joint Director	aslam.navaid@sbp.org.pk
9	Ashfaq Ahmad	Joint Director	ashfaq.iba@sbp.org.pk
10	Adnan Majid	Deputy Director	adnan.majid@sbp.org.pk
11	Farid Khan	Deputy Director	farid.khan@sbp.org.pk
12	Muhammad Usman Abbasi	Deputy Director	muhammad.usman3@sbp.org.pk
13	Bushra Shafique	Deputy Director	bushra.shafique@sbp.org.pk
14	Fatima Javaid	Deputy Director	fatima.javaid@sbp.org.pk
15	Mudassar Saleem	Assistant Director	mudassar.saleem@sbp.org.pk
16	Muhammad Amjad	Assistant Director	m.amjad@sbp.org.pk
17	Naveed Ahmed	Assistant Director	naveed.ahmed@sbp.org.pk
18	Yasmeen Abdul Ghani	Officer-IBD	yasmeen.ghani@sbp.org.pk
19	Saghir Ahmad	Officer-IBD	saghir.ahmad@sbp.org.pk

Mailing Address:
Islamic Banking Department, 7th Floor
State Bank of Pakistan
I.I. Chundrigar Road, Karachi.
Fax No. +92 21-9921 2472, UAN: +92 21 111-727-111
E-mail: ibd.helpdesk@sbp.org.pk
Webpage: http://www.sbp.org.pk/departments/ibd.htm